Introduction

Consumer policy and competition policy are logically and institutionally intertwined. But while economics has had immense influence on competition policy, it has had much less to do with consumer policy. So whatever else may be said of consumer policymakers, they are not, in Keynes's famous phrase, 'slaves of some defunct economist'. Indeed economics would seem at times not to be a very effectively employed servant to consumer policy. My theme, then, will be that economics can and should do more for consumer policy.

My plan is first to outline some of the main elements of UK consumer law and policy, and to note some underlying themes. Then I will discuss some complementarities and potential tensions between consumer policy and competition policy. Next I will take a step back to ask why public policy towards consumer contracts—and business dealings with consumers generally—need go beyond the provision of means to ensure that contracts are honoured. Why should the state impinge on freedom of contract? What is wrong with *caveat emptor*? The economics of information has helped to answer some such questions, and I will note some of the formative contributions in that area. Then I will attempt to show how the
economics of lock-in—a branch of competition economics—can help illuminate a range of consumer policy issues. Indeed it would appear that a number of ‘consumer’ or ‘fair trading’ issues are at root competition issues and hence amenable to competition analysis. Finally, I will mention some possibly fundamental limitations on what economics, as we know it, can contribute to consumer policy.

The discussion will concentrate mainly on information problems in markets. Of course market imperfections do not necessarily call for public policy solutions. Market mechanisms can often overcome information problems quite well. And where the benefits of policy intervention are judged to outweigh its costs, it is often better to improve consumer information—to help markets work better—than to restrict the choices available to consumers. The practical difficulties and dilemmas of seeking to do this are at the heart of consumer policy.

What is consumer policy?

What is meant by ‘consumer policy’ can be explained in two ways. One is to describe the subject matter of laws and regulations that are aimed at protecting consumers. These include measures regulating characteristics of:

- products—e.g. safety requirements;
- suppliers—e.g. professional qualifications;
- marketing methods—e.g. requirements on advertising;
- the purchasing process—e.g. in or from home;
- contract terms—e.g. in ‘small print’;
- an industry or sector—e.g. codes of practice.

There is quite a lot of consumer law and there are many enforcers of it. The Office of Fair Trading (OFT) has consumer law enforcement responsibilities in relation to consumer credit, misleading advertisements, unfair contract terms, distance selling, estate agents, package travel, and more.²

Some of this legislation was passed a while ago—for example the Consumer Credit Act 1974, which itself succeeded earlier generations of legislation on money lending. Some of the measures came from the implementation in the UK of recent European Community (EC) directives

² See www.oft.gov.uk for more information on the legislation under which the OFT has enforcement powers.
such as those on unfair contract terms in the 1990s and distance selling in 2000. Other legislation is new, notably the Enterprise Act 2002, which came into force in June this year. This Act does many things. Its Part 8 consolidates the enforcement—largely by way of injunction—of the consumer measures that were in the Fair Trading Act 1973 and the Stop Now Orders Regulations 2001. Further change is in prospect. For example, consumer credit legislation is under review. And in June this year the European Commission published a draft directive on unfair commercial practices, which could have far-reaching implications.

The other way to describe consumer policy is in terms of the fundamental problems that it seeks to prevent, cure or remedy. These can be put under three broad headings:

- duress and undue pressure;
- information problems pre-purchase;
- undue surprises post-purchase.

**Duress and undue pressure**

The common law of duress, and the equitable rules of undue influence, offer potential remedies to a contracting party subjected to kinds of improper pressure. In typical consumer situations, however, recourse to the courts by individuals seeking relief will often not be sensible or practical in view of the costs, risks and likely asymmetry of legal resources involved. For this and other reasons there is a body of legislation and public regulation aimed at protecting consumers from duress and undue pressure.

Required ‘cooling-off’ periods are a prime example. Cooling-off periods allow consumers to make, or rather unmake, decisions in unpressurised conditions, which also ought to reduce the opportunity and incentive for undue pressure to be exerted in the first place. The Consumer Credit Act 1974 to this end provides a seven day period of reflection for certain credit agreements borrowing against land during which no contact between the borrower and the lender is permitted. Consumers in the home are also protected from uninvited sellers under the Doorstep Selling Regulations. Sellers must inform consumers that they have a right to cancel for seven days following the making of the contract.

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3 See Treitel (2003, chapter 10).

Cooling-off and cancellation periods can also help in relation to some information problems—for example as an antidote to being misled at the point of sale.

Information problems pre-purchase

In many market situations consumers have less information about product characteristics than the supplier. This creates the possibility of consumers making poor decisions if firms exploited their information deficiencies. A substantial amount of regulation has been directed at this problem, including bans on misleading advertising, disclosure requirements, and product regulation.

The Control of Misleading Advertisements Regulations 1988 combat adverts that deceive, or are likely to deceive, with the effect of altering consumers’ economic behaviour or injuring a competitor. The regulations prevent the making of false statements and important facts being omitted which create a false impression.

As to disclosure requirements, the Consumer Credit Act, for instance, requires lenders prominently to state the APR (annual percentage rate) of loans as a guide for consumers of loan costs. The Distance Selling Regulations\(^5\) require suppliers to provide consumers with certain key information before they buy.

Undue surprises post-purchase

Undue post-purchase surprises, which are closely linked to information problems, can occur when key product characteristics become apparent only after the consumer is committed.

Regulation in this area includes the Distance Selling Regulations, which give consumers seven days to cancel distance contracts, and the Unfair Terms in Consumer Contracts Regulations 1999, which can be used to strike down unfair contract terms. Examples of unfair terms include denying redress to consumers, and terms that provide that the supplier can unilaterally vary terms without a valid reason after the conclusion of the contract.

In sum, there is a wide and growing range of consumer law and regulation in the UK. We are a long way from *caveat emptor*. Some would say too far; others would say not nearly far enough. I will return to the *caveat emptor* question shortly.

\(^5\) Consumer Protection (Distance Selling) Regulations 2000.
Quite another body of law is central to consumer policy in a wider sense — competition law. Indeed competition and consumer law should be seen as one subject, not two. In the UK the main elements of competition law are both recent on the statute book. The Competition Act 1998, which came into force in March 2000 and which mirrors the EC competition rules, prohibits anti-competitive agreements and abuse of market dominance. The competition provisions of the Enterprise Act 2002 concern mergers, market investigations and the new criminal offence of dishonest participation in hard-core cartels.

Competition is pro-consumer for the simple reason that rivalry among suppliers to serve customers well is good for customers. In such rivalry, the suppliers who serve customers best will prosper and those that serve them poorly will not.

By the incentives that this process gives to all firms, and by selecting the better from the poorer, efficiency and productivity in the economy as a whole are promoted. This is productivity in the properly consumer-oriented sense of Adam Smith:

Consumption is the sole end and purpose of all production; and the interest of the producer ought to be attended to only so far as it may be necessary for promoting that of the consumer. The maxim is so perfectly self-evident that it would be absurd to attempt to prove it.

Competition cannot work effectively unless customers are reasonably well informed about the choices before them. Uninformed choice is not effective choice, and without that there will not be effective competition. Informed choice has two elements — knowing what alternatives there are, and knowing about the characteristics of alternative offerings. In particular, what matters is the ability of customers to judge the prospective value for money, for them, of the alternatives on offer. That points to a fundamental question that many discussions about competition ignore, perhaps because they take its answer for granted: competition to do what?

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6 A stimulating analysis of the interface of competition and consumer protection, which stresses the importance of international cooperation, is given by FTC Chairman Muris (2002).
7 ‘Customer’ here refers not just to final consumers but also to business customers. Benefits from competition to customers up the supply chain should, however, flow through to final consumers.
8 Wealth of Nations, iv, 8. Adam Smith went on to say: ‘But in the mercantile system the interest of the consumer is almost constantly sacrificed to that of the producer; and it seems to consider production, and not consumption, as the ultimate end and object of all industry and commerce.’

Plus ça change.
Competition between fraudsters, for example, like competition between burglars, has no merit. Indeed the great system of property rights prevents competition in consumption and so gives incentives for productive activity, which expands the means of consumption. And intellectual property rights like patents prevent kinds of competition in production and so give incentives for competition in innovation, which expands the means of production and hence of consumption.\(^9\)

It cannot be taken for granted, however, that product market competition between firms is necessarily competition to serve customers well. That depends, and one of the things it depends on is the stance and effectiveness of consumer policy. In that sense competition and consumer policy are complementary.

For example, suppose that firms could with impunity seek business deceptively by way of misleading adverts. In the absence of market disciplines—e.g. from brand reputations—commercial incentives could well result in highly misleading adverts. Consumers could then be conned in large numbers, and fair-dealing businesses would lose out to the unscrupulous. (In fact this argument is a bit hasty. If all consumers realised that such adverts were meaningless puff, they would not be misled. But then the advertising would be deprived of informative value and market competition would be degraded in consequence.) Laws against misleading advertising can therefore help protect the competitive process—to the benefit of not only customers but also all fair-dealing businesses.

What requirements should be placed on adverts?\(^10\) An advert is clearly misleading if it makes false claims about material facts. An advert can also be misleading, even if literally true, if it would cause the ordinary person to make materially false inferences. But what if, more generally, an advert fails to correct false beliefs about material facts held by (some) consumers or fails to disclose facts that would change the behaviour of (some) consumers? Beyond some point disclosure requirements could even be counter-productive if, faced with information overload, consumers judged that it was not worth understanding much of the information presented.

More generally, there are points beyond which measures with pro-consumer intention (or stated rationale) can have contrary effects. Advertising again provides an example. Suppose that a professional body

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\(^9\) This point about levels of competition, due to von Weizsäcker, is discussed in Vickers (1995). The optimality of existing law on intellectual property rights, and its appropriate relation to competition law, are good questions not addressed here.

\(^10\) The examples in this paragraph are from Beales, Craswell and Salop (1981).
considers price advertising unseemly and so bans it, perhaps on the grounds that some consumers might wrongly think that lower price necessarily meant better value. While it might be true that lower price did not always mean better value—e.g. because some higher priced suppliers provided sufficiently higher quality—such a ban on price advertising would almost certainly be competition-blunting and detrimental to consumers.

To take another example, suppose there were a ‘pro-consumer’ regulatory requirement that all passengers on flights lasting more than an hour were served ‘free’ three-course meals and drinks from a well-stocked bar. That would, among other things, keep ‘no-frills’ airlines out of the market. They would not compete with each other, or against full service carriers. The result would be less competition, less choice, and less consumer satisfaction. We all know that there is no such thing as a free lunch. Requiring ‘free’ lunches could just make things more expensive.

Clearly there are, at times, balances to be struck. The structure of competition law explicitly allows for this. Thus the competition law prohibition against anti-competitive agreements allows such agreements to be exempted from prohibition if they bring economic benefits of which consumers get a fair share, are indispensable to achieving those benefits, and do not eliminate competition. Likewise, the new UK merger law allows regard to relevant customer benefits in the consideration of mergers that might lessen competition. Needless to say, agreements and mergers that are anti-competitive are normally anti-consumer as a result, but competition law sensibly allows scope for proven exceptions to the rule.11

Besides general complementarities and occasional tensions between competition and consumer policies, there are underlying analytical connections arising from the fact that a number of ‘consumer’ problems can be seen as micro competition problems. The ill-informed consumer who is unaware of alternative choices, and who is in a situation where the supplier can discriminate against that consumer, is in effect subject to monopoly power.12 So too is the consumer who is locked into a long-term arrangement where the supplier has excessive discretion to vary the terms. Analytical connections of this sort will be illustrated in more detail later.

More generally, there are some situations where a benchmark for assessing the fairness of a market outcome is by reference to competition.

11 The exceptions are not to be lightly accepted and those seeking to show that an anti-competitive merger, say, is nonetheless pro-consumer carry a heavy burden of proof.
12 If the seller cannot discriminate, so that the same deal is on offer to all, then the unaware consumer may be protected from exploitation by the surrounding competition to supply more aware consumers.
Indeed one interpretation of the ancient notion of the just price is that it is a moral guide for non-competitive situations—e.g. where one party has all the bargaining power—based on what the price would have been if there had been competition and choice.\textsuperscript{13} Of course this is not to say that all is fair that results from competition.

Having underlined that competition is absolutely fundamental to consumer policy, I want to concentrate now on consumer policy issues other than competition. This can be done most simply by supposing that there is effective competition among sellers in the settings discussed below. For the most part, however, the discussion applies equally to settings where there is market power.

What is wrong with \textit{caveat emptor}?\textsuperscript{14}

A solid analytical foundation for consumer policy requires a clear answer to the question of what is wrong with \textit{caveat emptor} and, more generally, what is wrong with freedom of contract.

Where contracts, including consumer purchases, have not been freely entered into, there is a clear objection to the state sticking to contract enforcement. Those who have been forced into contracts by duress and undue pressure, or conned into contracts by fraud, have long been protected by the courts and are protected under legislation. There are also clear public policy grounds for intervening against contracts with significant adverse effects on third parties. (Cartels are a prime example.) But why should public policy limit freedom of contract in respect of contracts freely entered into that have no effects beyond the contracting parties?

This question is not rhetorical. In basic settings with symmetric information between a buyer and a seller, say, freedom of contract should lead to an efficient outcome—the gains from trade should be maximised.\textsuperscript{15} Sellers would have every incentive to offer terms that deliver value for money to consumers as efficiently as possible. If a sales contract contained a term that benefited the consumer less than it cost the seller—or harmed

\textsuperscript{13} This point about fairness, and some others in this lecture, was discussed in Vickers (2001).
\textsuperscript{14} Craswell (2000) is a succinct discussion of the law and economics of freedom of contract, which was given as the 1994 Coase Lecture at the University of Chicago. For a recent full essay on the contribution of economics to (US) contract law, see Posner (2003) and the comments thereon in the same issue of the \textit{Yale Law Journal}.
\textsuperscript{15} And with competition between sellers the gains in excess of the seller's costs (including any reward for innovation) will flow to consumers.
the consumer more than it benefited the seller—then that term would be inefficient and would go. Without the inefficient term the seller would be able to offer a deal that was better both for the seller and the consumer. Likewise there would be every incentive to include efficient terms. In short, deals would be tailored efficiently by unfettered market participants.16

A third party such as a regulator without superior information, no matter how benevolent, would not be able to improve things. Indeed in the simple setting at hand external constraints on freedom of contract would, if they bit, get in the way of efficiency and be correspondingly detrimental to consumers. If the third party had better information than market participants, then the best thing would be to release that information—to inform, not curb, free contracting.

Thus there is a straightforward argument that free contracting will yield efficient results. But the argument holds solidly only when buyer and seller have the same information. When, as in a host of practical consumer situations, there are information problems, inefficiency and consumer detriment can result from free contracting. Then regulation can potentially improve things. Whether or not regulation actually improves things depends on how well it is framed and conducted.

So now let us drop the assumption of symmetric information and consider some settings where sellers have important information that buyers lack. Situations are also common where buyers have information that sellers do not—e.g. regarding risks in insurance markets—but they are beyond the scope of this discussion.17

Some economics of lemons and lawyers

Lemons—in the sense of dodgy used cars—were the subject of the path-breaking paper on the economics of imperfect information in product markets by Akerlof (1970). The seller of a used car is likely to know more about its quality than prospective buyers. Suppose for illustration that buyers cannot tell pre-purchase which used cars are lemons. At any given price, owners of lemons will be keener to sell their cars than owners of good

16 Of course, even in this basic setting with symmetric information, the law can greatly assist the contracting process by specifying what is to happen in contingencies not explicitly covered by the contract between the parties.
17 Stiglitz (1989) is a general survey of the economics of imperfect information in product markets. Carlton and Perloff (1999, part IV) gives a clear analysis of the issues.
cars. In that case, the story goes, the second-hand market will consist
disproportionately of lemons, and used car prices will be correspondingly
low. To paraphrase Gresham’s Law, bad cars drive out good.

This information gap could frustrate trade of good used cars. There
are economic models in which buyers will not buy good cars for (justified)
fear that they are buying a lemon, and potential sellers of good cars won’t
sell them because the market price is low, reflecting the prevalence of
lemons on offer. There might be owners of good used cars who would be
delighted to sell them for £6,000—but not for the lemon-reflective market
price of £3,000—and people who would be delighted to buy those good
cars at that price. But unless the good quality is evident in advance, the
gains from such trades will go begging.

Related problems can arise in markets where sellers can choose the
quality of their product or service on offer, but where buyers cannot
determine quality by inspection. (These are called ‘experience goods’
because quality becomes known only through experience.) Providing
higher quality costs suppliers more than providing lower quality, but if
consumers cannot tell the difference when they make their purchase deci-
sions, there is no immediate commercial incentive to provide better quality.
Bad quality could drive out good. This is detrimental to the extent that
the consumer benefit of higher quality exceeds the extra cost. (The very
simple economic model in the annex to this paper formally illustrates this
point among others.)

Such information problems—or potential problems—are inherent in
a host of economic settings. If it is impossible to contract on quality, then
free contracting might result in poor outcomes, contrary to the symmetric
information setting discussed earlier. But it certainly does not at this
point follow that public intervention is called for.

Market forces and enterprise might themselves spur reasonably good
solutions. To go back to the car example, there could be handsome
rewards for a dealer who could both establish which were good used cars
and credibly persuade prospective buyers of their quality. Then the gains
from trading good cars would not go begging, or at least not to such an
extent. But how can the dealer—or the seller of any product whose
quality cannot be verified directly at the time of purchase—credibly per-
suade buyers that quality is high? There are all sorts of ways, which work
more or less well depending on the circumstances. For example, war-
ranties and guarantees may help overcome information asymmetries—
though they can also be subject to information asymmetry problems
themselves.
Of widespread importance in overcoming information problems is market reputation.\textsuperscript{18} Repeat purchases can give sellers the ability and incentive to build and maintain reputations for high quality supply. (This too is explored formally in the model in the annex.) If a seller of high quality products can command a price premium that more than compensates for the extra cost of providing high quality, then even if consumers cannot determine quality pre-purchase, the seller will provide high quality in order to attract future purchases.

Those future purchases could be from past customers and/or new customers who learn of the good experiences of others. Novels—perfect examples of experience goods—illustrate this last point.\textsuperscript{19} Word-of-mouth, book reviews, blurbs, website comments, perhaps even the verdicts of prize committees, as well as the reputations of publishers and established authors, all help to convey some information. Public regulation of the ‘quality’ of novels (or novelists) would, to put it mildly, be an absurd farce.

Brands can be important bearers of reputation. First, by creating reputational links across products, they can strengthen the repeat purchase mechanism. Suppose that the Bliss Soup Company supplies fifty-two varieties (though none lemon), that I buy soup once a week, and that I like variety. Then I might buy Bliss soup every week though Bliss tomato soup but once a year. Second, brands can facilitate the spreading of the word about good (or poor) quality. Third, brands can facilitate the conveying of information about product quality by advertising.

But there are many products and services for which purchasing is relatively infrequent, including (one hopes) plumbing, car repair and funerals.\textsuperscript{20} Brands might work effectively in some contexts, but clearly not in others. And there are some products—known as ‘credence goods’ since their quality has to be taken on trust—where consumers cannot readily ascertain the quality of service even with the benefit of experience. For example, with many professional services it is inevitable that the customer knows less than the provider inasmuch as expert knowledge is what is supplied.

So while market mechanisms can remedy a range of potential information problems, there are limits. What, then, can public intervention usefully do? Even where there are good grounds to expect that public intervention has the potential to make things better, it must always be

\textsuperscript{18} Klein and Leffler (1981) was a pioneering paper on the role of market forces in assuring quality supply. The reputational equilibrium analysis in the annex is also along the lines of that paper.

\textsuperscript{19} I owe this example to Mark Armstrong.

\textsuperscript{20} These are also products and services for which shopping around might not be very practical.
remembered that intervention can make things worse, and the earlier discussion of the merits of freedom of contract is one reminder of this.

Leland’s (1979) paper on licensing illustrates a fundamental trade-off here. Suppose that regulation can effectively prescribe a minimum permitted quality level. No seller supplying below that level is licensed to operate. Such regulation is a direct restriction on freedom to contract—it bans supply of products below the minimum quality level. In principle this form of regulation could be very beneficial. If bad quality is banned, it cannot drive out good quality.

However, this point needs to be treated with care. Remember that the lemons problem is that, because of asymmetric information, the market gravitates to a low quality/low price equilibrium that is inefficient insofar as desirable supplies of higher quality products do not happen. But higher quality costs more, so is not intrinsically good, nor is low quality—intrinsically bad. The aim is market provision of the cost/quality combinations that consumers want. The risk, then, is that as the minimum quality level is raised, buyers and sellers who would happily have traded low cost/low quality products are banned from doing so. Exclusion of some sellers or products from the market could therefore have the effect of excluding some consumers, and of forcing others to pay more—albeit for higher quality—than they would have done in the absence of regulation. This is not an argument against regulation but a factor that regulatory design should take into account.

There are practical issues too. Regulating product quality can be difficult and costly. If quality were easily observed and monitored, it might anyway be a subject of market contracting, in which case there would be less need for regulation. And in fact quality regulation often applies to supplier characteristics rather than product characteristics.

Thus professional services markets typically have licensing (or some equivalent) so that only suppliers that have attained prescribed qualifications, which require extensive training and investment, may operate. Lower quality suppliers, unable to make the grade, are excluded. Suppliers who have trained and invested may have stronger incentives, as well as greater ability, to supply good quality.21

Again, however, there is the fundamental trade-off resulting from the fact that higher regulatory requirements raise costs as well as quality. Moreover, where regulation effectively limits entry into a market, higher regulatory requirements can increase prices faster than costs, which is fine

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21 Shapiro (1986) analyses these issues.
for those qualified to supply but a factor detrimental to consumers. This happens not because the qualified suppliers collude to restrict supply below industry capacity, but because the regulation itself limits capacity, which raises prices and profits even if all suppliers compete so as to operate at full capacity.

Naturally Adam Smith saw this point. He observed the monopolistic tendency of

all those laws which restrain, in particular employments, the competition to a smaller number than might otherwise go into them. [. . .] They are a sort of enlarged monopolies, and may frequently, for ages together, and in whole classes of employments, keep up the market price of particular commodities above the natural price. [. . .] Such enhancements of the market price may last as long as the regulations of police which give occasion to them.22

That points to a concern with self-regulation. If regulation is determined by qualified suppliers, there is a clear economic incentive for them to set the standard higher than the level that would best serve consumers.23 Moreover, the self-regulatory profession might well have an economic interest in a wide range of business being reserved to fully qualified suppliers even when some types of that business could perfectly well be conducted by suppliers with less extensive qualifications.

In short, when, as is often the case, consumers know less than suppliers, free contracting cannot be relied upon to deliver efficiency. There is a tendency to inefficiently low quality, which market forces such as reputation mechanisms might or might not be able to overcome. Regulating product quality or supplier quality can sometimes ameliorate the quality problem, but care is needed not unduly to frustrate deals that would be efficient for some groups of consumers. As regards quality regulation the interests of consumers and of incumbent suppliers can diverge even if there is effective competition between those suppliers.

In view of the difficulties of quality regulation, one may wonder whether regulation might often be better directed at information provision than product or supplier quality. As Beales et al. (1981) put it: ‘Information remedies allow consumers to protect themselves according to personal preferences rather than place on regulators the difficult task of compromising diverse preferences with a common standard.’ Indeed much consumer policy is aimed at improving consumer information, and I shall come back to this issue later.

22 Wealth of Nations, i, 7.
23 Shaked and Sutton (1981) examine these issues.
Parallels with lock-in economics

Many markets are characterised by switching costs. Consumers may have an entirely free choice of which supplier to choose at first, but having chosen they face costs of switching from their existing supplier to another. If switching costs are high, consumers may be effectively locked in.\(^\text{24}\)

Switching costs can arise for a variety of reasons. For example, in everyday examples such as razors/blades, cameras/films, consoles/games and cars/parts, the ‘aftermarket’ product must be compatible technologically with the ‘primary’ market product. Switching costs can arise from the hassle or perceived complexity of changing supplier (as with some banking services perhaps) or simply from the costs of learning about alternative suppliers. Lock-in can arise also from contracts. Indeed the very point of many long-term contracts is lock-in so that one party can receive benefits in return for future commitments to another. Switching costs may be natural or created (as with some ‘loyalty rebates’ perhaps). They may be benign or they may give rise to problems. In particular they may give rise to competition problems and problems of \textit{ex post} exploitation. Sometimes policy intervention can help reduce switching costs; sometimes it cannot.

The economics of lock-in and switching costs was pioneered especially by Paul Klemperer and is surveyed comprehensively by Farrell and Klemperer (2003). My aim here is certainly not to discuss this large and rich subject, but to suggest that it can be useful in thinking about some ‘consumer’ and ‘fair trading’ issues.

Consumer lock-in \textit{ex post} is quite consistent with competition between firms to win custom \textit{ex ante}. Indeed the prospect of lock-in can well encourage extra competition \textit{ex ante}, typically resulting in a ‘bargains-then-ripoffs’ pattern of pricing, as Farrell and Klemperer put it. They note that it is not just a question of prices—exploitation \textit{ex post} can involve low quality rather than high price.

If there is effective competition \textit{ex ante}, so that profits are not excessive, then what is wrong with bargains-then-ripoffs? There are two problems. (The model in the annex illustrates both.) The first is that consumers could have got better overall deals with a more balanced pattern of pricing/quality. Put another way, utility is inefficiently delivered to

\(^{24}\) Lock-in can also arise from network effects, which arise when the consumer benefit from a product varies positively with the number of others in the same network (or compatible networks). Computer systems are an example.
consumers. As discussed earlier, this problem might be ameliorated insofar as sellers can credibly commit to future price/quality, for example by reputation. But reputation-backed promises work only in some circumstances.

The second problem is that consumers see and act on the bargain but do not realise that the non-bargain will follow. Then many could regret buying at all. It might be said that consumers ought to think ahead. That is certainly good advice but not a complete answer to the problem. For practical purposes thinking ahead needs practical information—i.e. relevant information that can be readily assimilated by an ordinary reasonable person.

This question of practical information can be illustrated by the example of credit cards. As with other credit products, credit card adverts and agreements must prominently display the annual percentage rate (APR) of the credit arrangement. The APR is the cost to the consumer of the credit expressed as an annual percentage rate. To give a measure of the overall cost of credit, the APR captures not just interest charges but also any annual fee, for example.

Two years ago the OFT successfully took action to stop 28 credit card providers advertising as ‘introductory APRs’ the low interest rate in offerings that have a low interest rate for an introductory period followed by a higher interest rate. Since the point of the APR is to give a measure of the overall cost of credit—not just any introductory ‘bargain’—the advertising at issue hindered consumers trying to assess the overall cost of credit under those deals. This was an example of intervention to improve practical consumer information by removing potentially misleading statements.

But what about steps to make the practical information base positively better, rather than just stop it being degraded? An APR is a single number. Credit card products are (increasingly) complex, and moreover the cost of credit to a particular consumer depends on exactly how that consumer uses the credit facility (a point that gives rise to tricky issues of APR calculation). No single number can therefore capture all relevant practical information about the cost of credit. More information than the APR needs to be routinely and prominently accessible to consumers. What additional information is most important, and how should it be displayed? Government and industry are working on this now.

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26 To put it more neutrally than the emotive term ‘rip-off’.
This can be related back to the earlier discussion of asymmetric information. In a way, there is symmetry of information between the consumer and the card issuer. Each has access to the detailed terms of the credit card agreement, a calculator, and all the relevant consumer credit legislation, directives, regulations and case law on interpretation. The card issuer, who might have a million cardholders, has every incentive and the ability to understand all this with great thoroughness. But it would be absurd to say that the rational consumer would or should do the same. Indeed it would be irrational to do so—except perhaps for those who find ecstasy in small print—given the (possibly infinite) effort required.

The general point here is that raw information is not always practical information, and that processing information to make it practical can be very costly. Suppliers have economies of scale in this regard that consumers do not. Large asymmetries of practical information can result.

Pursuing this theme, consider contract terms dealing with unlikely but possible contingencies—for example the possibility that I will be late with a loan or hire purchase payment, or forced to cancel my package holiday booking. Imagine that small print in the contract required me effectively to pay a high price, disproportionate to any cost involved, if such contingencies arose and that the supplier would reap a correspondingly high profit. For example, suppose that the late payment allowed the lender to invoke a higher interest rate henceforth, or to get damages as if I had repudiated the whole contract, or in the cancellation example to make no refund even though the holiday that I had booked was easily resellable.

Even the most far-sighted of consumers might reasonably not have thought through the implications of such contract terms, still less factored them into their purchase choices. But for the suppliers the contingencies concerned could be a considerable source of (anticipated) profit. In this context there is a limit to the protection afforded to consumers by the law on breach of contract, which few consumers might be willing or able to pursue in any event.27

There are, however, the regulations on unfair terms in consumer contracts, which have been in force since 1995. These apply only to standard form contracts with consumers, and not to individually negotiated terms. They do not apply to core contract terms—those describing the subject matter of the contract and the price. The regulations say that unfair terms

27 See Treitel (2003, chapter 19), including the discussion of the contrasting Financings and Lombard cases on late payments in contracts for hire. The law on unfair contract terms is discussed in chapter 7 of Treitel.
are not binding on the consumer. The concepts of good faith and of imbalance between seller and consumer are involved in assessing unfairness. The regulations also require terms to be expressed in plain, intelligible language.

On the basis of this sketch the unfair contract terms regulations might seem dangerously vague. In practice, although it is relatively early days, they have been a useful and practical tool. Thousands of contract terms of relevance to millions of consumers have been amended and made fairer without, in my view, excessive interventionism. Guidance and negotiation have been effective in, for example, the housing and travel sectors, and judicial opinion at the highest level has clarified interpretation of the regulations.28

At first sight unfair contract terms might seem a long way from the economics of lock-in. They are certainly an unusual application of it. But on reflection the parallels seem close. In a literal sense the consumer is contractually locked in. The analogue of the poor deal in the ‘aftermarket’ is the bad deal in the contingency that the unfair contract term relates to. Whereas in the standard lock-in literature the consumer foresees the bad deal, the victim of the unfair contract term might, without being irrational, not realise that it was there, or what it would entail. So there are information problems pre-purchase and resulting potential for undue surprise.

The regulations on unfair terms in consumer contracts seem to me to provide quite an appealing kind of remedy, including in economic terms. They advance contract clarity. They do not impinge on freedom of contract in respect of core terms—including price—or individually negotiated terms. They impinge only on contract terms that are contrary to good faith and where there is an imbalance against the consumer. A risk of restricting freedom of contract is that contract terms that are efficient and mutually beneficial for some parties are ruled out. This risk seems relatively low in relation to the kinds of contract term liable to be rendered ineffective by the regulations.29

Another way to view the unfair contract terms question, and indeed some other aspects of consumer law, is as micro-competition policy. In

28 In the case of First National Bank, which concerned interest on a loan after judgment had been given against a creditor. The OFT lost the case in the House of Lords having won in the Court of Appeal. The Lords Judgment is nonetheless of considerable assistance in clarifying the application of the regulations.
29 OFT action has led to the amendment or removal of contract terms relating to diverse issues including, for example, the length of notice required to cancel mobile phone contracts, the denial by landlords of their legal liability to repair properties, and the demand for full payment in advance for home improvements.
situations of lock-in the consumer is in effect individually vulnerable to the exploitation of market power *ex post*. The consumer might be compensated in part for this by getting a correspondingly good deal as a result of *ex ante* competition. But the outcome is still inefficient—and worse if there are undue surprises. The consumer might be especially vulnerable to the exploitation of such market power—e.g. by disproportionate penalty payments—in contingencies that were not fully anticipated in advance. So one way to see the consumer policies that address such issues is as policy to combat micro-competition problems in large numbers. On this view, much consumer policy *is* competition policy.

**Conclusion**

The general goal of consumer policy—in the broad sense that embraces competition policy—is to ensure that consumers can make unpressured and well-informed choices among the offerings of competing suppliers. Commercial incentives are then directed at serving consumers well, and hence at efficiency, productivity and innovation.

In an ideal world freedom of contract—including *caveat emptor*—would be a good policy, but that is not the world that consumers live in. Information problems abound. Much consumer policy therefore seeks to inform and/or constrain the process of contracting—who can supply and how—and what may be supplied.

While no one could doubt the wisdom of banning quacks practising as doctors, or fraudulent adverts, there eventually comes a point beyond which constraining freedom of contract further brings costs that outweigh benefits. These costs, which consumers ultimately bear and which may be hidden from view, can stem from less choice and competition as well as the cost of regulation itself.

Indeed, the best solutions often involve better consumer information rather than less consumer and producer choice. But improving consumer information is often easier said than done, especially information that is of immediate and direct practical use—for as consumers we are all boundedly rational, and rationally so.

The underlying policy questions of when and how to constrain contracting, and of how to enhance practical consumer information, are hard. Economics—especially that based on assumptions of free and boundless rationality—cannot itself answer those questions. But together
with other disciplines it can surely help. Economics can do considerably more—by way of analysis of markets, producers and especially consumers—to assist the continuing development of consumer law and policy, and its application.

Bibliography


A simple competitive model with consumer detriment

This annex presents a simple model in which there is perfect competition but consumer detriment if firms cannot pre-commit their behaviour with respect to a product attribute that cannot be observed by consumers at the time of purchase. The model also illustrates how reputation might be able to ameliorate this problem. (And it is shown how this issue can be analysed using ‘competition in utility’ methods.)

Though simple, the model is capable of a variety of interpretations. For example, the product attribute might be some aspect of quality, or the price of an associated product purchased in an aftermarket. This breadth of interpretation illustrates how some ‘consumer’ and ‘competition’ issues can have similarities in essential respects. The simplicity of the model however comes at the expense of its excluding consumer diversity as to price/quality trade-offs, which is central to much consumer policy economics, as the earlier discussion emphasised. Thus the model illustrates some, but by no means all, of the issues discussed in the text.

The model

Consumers are offered a product at price $p$. Consumers care about some attribute $a$ of the product that they cannot observe until after they have purchased. Consumers like lower $a$, so it can be thought of, for example, as a negative measure of quality. A consumer whose opportunity cost is $r$ gets surplus of $v(p, a)$ if they buy some of the product, and zero surplus otherwise. Naturally $v$ is decreasing in $p$ and $a$. The distribution of $r$ is given by $F(r)$. Firms are symmetric and have constant returns to scale. Profit per consumer is $\pi(p, a)$.

Competitive equilibrium with no commitment and no surprises

Competitive equilibrium involves the zero profit condition that $\pi(p, a) = 0$. Without the ability to pre-commit, each firm will choose $a$ to maximise $\pi(p, a)$. This entails first-order condition $\partial \pi / \partial a = 0$. Let $\varphi(p)$ be the maximum value of $\pi(p, \cdot)$. Figure 1 shows the equilibrium combination $\{p, a\}$. The figure also shows the optimal $\{p^*, a^*\}$ combination that maximises consumer utility $v$ subject to $\pi = 0$.

The pre-commitment problem means that utility is delivered inefficiently to consumers notwithstanding competition. Relative to the optimum, price and quality are both too low. Consumers would willingly pay the cost of improving quality to the level corresponding to $a^*$, but they are stuck with low quality. If consumers anticipate this problem, only those with $r$ less than $r^* = v(p^*, a^*)$ will buy, whereas those with $r$ up to $r^* = v(p^*, a^*)$ would buy at the optimum. In respect of the consumers who buy in equilibrium, the total welfare loss relative to the optimum is $(r^* - r)F(r)$. There is a further welfare loss in respect of the consumers with opportunity cost $r$ between $r$ and $r^*$, who would have bought at the optimum but do not in equilibrium. These welfare losses are respectively areas $x$ and $y$ in Figure 2.
Figure 1. Optimum and no-commitment equilibrium.

Figure 2. Welfare losses.
Nasty surprises

If consumers fail to realise that the attribute revealed post-purchase will be poor, some will regret having bought. For example, suppose that consumers expect that they will receive the optimum level of surplus \( r^* \). Then those with \( r < r^* \) would have done better not to buy. Adding their welfare loss (which corresponds to area \( z \) in Figure 2) to that above gives an overall welfare loss of \( (r^* - r)F(r^*) \).

Can reputation break the no-commitment equilibrium?

Let us return to the no surprises case and ask whether a firm could credibly promise not to give consumers poor \( a \) after they have purchased. Assume that promises are credible if and only if it is in the firm’s interest to keep a reputation for promise-keeping.

Suppose that the firm promises to provide quality level \( \bar{a} \) and charges price \( \bar{p} \), where \( v(\bar{p}, \bar{a}) > r \) and \( \pi(\bar{p}, \bar{a}) \geq 0 \). In other words, the firm promises a better deal than in the competitive no-commitment equilibrium. Is the promise credible?

Let \( \delta < 1 \) be the weight that the firm places on profit in the next following period of time relative to the current period. Thus \( \delta \) can be thought of as a discount factor. Suppose that the firm gets repeat purchases so long as it keeps the promise. That is worth \( \pi(\bar{p}, \bar{a})/(1 - \delta) \). Suppose that if the firm cheats on its promise, it will never be trusted again and so will make no further profit. Then it will make profit \( \varphi(\bar{p}) \) on the cheated consumers, and zero profit thereafter.

For the promise to pass the credibility test it must therefore be the case that \( \pi(\bar{p}, \bar{a}) \geq (1 - \delta)\varphi(\bar{p}) \). Since \( \pi(\bar{p}, \bar{a}) \geq 0 \), it must be that \( \varphi(\bar{p}) > 0 \), and therefore \( \pi(\bar{p}, \bar{a}) > 0 \). This is the familiar point that reputational incentives require positive—in other words, supra-competitive—profits. Otherwise there is no incentive not to cut and run. For consumers this profit is obviously a disadvantage. Indeed the disadvantage might outweigh the better mix of \( p \) and \( a \) in a candidate reputational equilibrium, in which case that candidate cannot defeat the original no-commitment equilibrium.

The highest level of consumer surplus consistent with the firm not having an incentive to cheat is found by maximising \( v(p, a) \) subject to the constraint that \( \pi(p, a) \geq (1 - \delta)\varphi(p) \). At that constrained optimum, the mix of \( p \) and \( a \) is still inefficient—price and quality remain too low—but to a lesser degree than in the original no-commitment equilibrium. The reason why \( p \) is inefficiently low here is that lower \( p \) means lower \( \varphi(p) \) and so a lower incentive to cheat. There is a trade-off between weakening the incentive to cheat and efficiency.

The best credible reputational equilibrium is better than the no-commitment equilibrium if \( \delta > 0 \). This follows from \( \pi(\bar{p}, \bar{a}) = \varphi(\bar{p}) = 0 \) and the fact that there is slack in the no-cheating constraint \( \pi(\bar{p}, \bar{a}) - (1 - \delta)\varphi(\bar{p}) \geq 0 \) around the no-commitment equilibrium \( \{\bar{p}, \bar{a}\} \). (At that equilibrium \( \pi \) has a zero derivative with respect to \( a \) and the same derivative as \( \varphi \) with respect to \( p \).) It follows that there are small changes in \( p \) and \( a \) around the no-commitment equilibrium—involving higher \( p \) and lower \( a \)—that increase \( v \) and also increase profit without breaching the no-cheating constraint. In terms of Figure 1 such moves are south-east from \( \{\bar{p}, \bar{a}\} \) and below the indifference curve corresponding to \( \varphi \).
Example

Perhaps the simplest example of this framework is when there is constant unit cost \( c \) and when \( v \) is additively separable in \( p \) and \( a \). Indeed let \( v \) take the particular form

\[
v(p, a) = \frac{h}{k + p} + \frac{h}{k + a} = s + t,
\]

where \( s \) and \( t \) are the sub-utilities relating to \( p \) and \( a \) respectively. This yields a very simple representation in terms of consumer utility. Normalise units so that \( h = k + c \). Then converting to utility space following the approach of Armstrong and Vickers (2001), it follows that profit is the simple quadratic in \( s \) and \( t \):

\[
\pi = (s - s^2) + (t - t^2).
\]

At the optimum: \( s^* = t^* = 1 \), \( v^* = 2 \) and \( \pi^* = 0 \).

At the no-commitment equilibrium: \( s = \frac{1}{2} (1 + \sqrt{2}) \), \( t = \frac{1}{2} \), \( v = 1 + \sqrt{\frac{1}{2}} \) and \( \pi = 0 \).

At the reputational equilibrium: \( \bar{v} = 1 + \sqrt{\alpha(1+\delta)} \) and \( \bar{\pi} = \frac{\delta(1-\delta)}{2(1+\delta)} \).

This illustrates how the inability to pre-commit—and the consequent bargain-and-ripoff pattern—is bad for consumers even with perfect competition ex ante. It also shows how reputation can improve things, to a degree depending on \( \delta \), though not enough to restore optimum efficiency for consumers unless \( \delta = 1 \). Indeed note that the reputational equilibrium equates with the optimum when \( \delta = 1 \) and with no-commitment equilibrium when \( \delta = 0 \). Note also how profit is generally positive at the reputational equilibrium.

Figure 3 shows this example in \((s, t)\) utility space. Iso-profit contours are circles centered on \((\frac{1}{2}, \frac{1}{2})\) and the zero-profit contour is the circle shown passing through the origin, which has radius \( \sqrt{\frac{1}{2}} \). Consumer welfare contours are negatively sloped \( 45^\circ \) lines. The reputation constraint (drawn for \( \delta = 0.25 \)) is the ellipse. The figure shows the optimum (the highest consumer welfare contour shown), the no-commitment equilibrium (the lowest one) and the reputation equilibrium (the middle one).

Aftermarket inefficiency: comment

One natural interpretation of the simple model presented above is as a model of competition in a setting where consumers desire the services of systems that consist of a primary component (sold at price \( p \)) and complementary products, which work only with the corresponding primary component, that are sold (at price \( a \)) in an aftermarket.

The pricing pattern of low \( p \) then high \( a \) is a standard feature of models of markets with lock-in or switching costs. (This is Farrell and Klemperer’s ‘bargains-then-ripoffs’ pattern.) The question of whether reputational considerations allow more efficient outcomes has been investigated by, among others, Borenstein et al. (2000), whose central result is that in all steady-state equilibria price in the aftermarket will exceed marginal cost despite competition in the primary market. One of their assumptions is that consumers expect future aftermarket prices to be the same as the current aftermarket price.
The model in this annex does not make such an assumption but yields a similar—and arguably stronger—result for the equilibrium that maximises consumer surplus \( v(p, a) \) subject to the reputational 'no-cheating' constraint. There are two reasons why \( a \) then exceeds the optimum \( a^* \) (which would correspond to marginal cost pricing). First, at the reputational equilibrium the firm makes positive profit. Otherwise it would have an incentive to cheat in the aftermarket. The requisite positive profit is akin to a fixed cost that must be covered by mark-ups of price over marginal cost. Second, as shown above, the mix of \( p \) and \( a \) is suboptimal at the reputational equilibrium. The aftermarket price \( a \) is inefficiently high relative to \( p \) because the incentive to cheat is inversely related to \( p \). These are reinforcing reasons why aftermarket price is higher at the reputational equilibrium than at the optimum.