Behavioural Economics as a tool for understanding Competition Agency Behaviour

The following speech was held at the Vienna Competition Conference 2010 and attempts to map how the lessons from behavioural economics can help us understand competition agency behaviour and perhaps point to some steps we can take to ameliorate their effects.

Von Phil Evans

Good afternoon, ladies and gentlemen, and let me start by saying what a pleasure it is to be here talking to such a distinguished audience about a topic that is very close to my heart. I have spent many years working on competition policy from a consumer standpoint and so have followed the rise in prominence of behavioural economics with a particular interest.

I must also start by making a particular disclaimer. As my biographical note shows I am a senior consultant to Fipra, the specialist public affairs network and a mem-ber of the UK Competition Commision. I am thus blessed with two Chairmen and, today, am doubly blessed as both of my Chairmen are sat in the audience. With some certainty I can firmly state that all the views I express today are my own, and my own alone.

As I mentioned in my opening comment behavioural economics has been a topic of great interest to me personally through my previous career as a policy adviser in the UK consumer movement. My first formal involvement in the field came with an article I wrote for the Consumer Policy Review on the topic of behavioural economics way back in 1995. Of course, to those of us with greying hair 1995 sounds like it should only be yesterday, but over the intervening fifteen years I have followed the spread of the topic with interest.

That spread has not been without its struggles or difficulties. I well remember visiting both the Office of Fair Trading and the Financial Services Authority in the UK to give talks to their economics teams on behavioural economics. On both occasions I was met with some scepticism and a general response of “interesting – but what use is all this”. Such a response is not to be ignored and indeed points to that characteristic of competition authorities that is often most worth protecting – their scepticism of all claims.

The initial scepticism of authorities towards behavioural economics has given way to more acceptance and indeed adoption of the approaches suggested in behavioural economics. Of course the age of behavioural economics, now running towards six decades, if we take our starting point as Simon's work on bounded rationality, points to a gradual process of attrition. In reality, however, authorities have, in the great tradition of all economics, adopted elements of behavioural economics without really realising that they were doing precisely that! In many ways we are all behavioural economists now!

In the true nature of competition agencies and the supporting community new variations in any approach are taken on board only when they add value to the existing stock of knowledge. Over the last decade or so competition agencies have increased their focus on consumer welfare. While in the USA much of that focus has centred on a rather orthodox Chicago School classicist approach which has tended to presume consumer ration-ality, the approach in Europe has been much more nuanced. A good deal of this has probably come from the many different roads travelled by the European compe-tition community with roots variously in ordo-liberalism, pragmatic liberalism and various approaches lack-ing formal monickers!

The increasing focus on the consumer has moved most authorities into the territory already occupied by the likes of behavioural economists, psychologists, anthro-pologists and sociologists. When we, as authorities and competition advocates, start to ask questions about how consumers behave, why they respond to certain stimuli in the way they do and how we can tailor our decisions and investigation processes best to reflect this learning we are forced to realise that our existing tools are inadequate. Bit by bit, and decision by decision we are adopting elements of behavioural economics almost by stealth. Indeed it is difficult now to read a credible competition assessment that does not recognise the complicated nature of consumer decision making and the need to ensure that remedies are able to reflect this complexity.

I am thus fairly sanguine about how the competition community is adopting and adapting to the lessons of behavioural economics. Indeed, my fellow panellists have talked with greater eloquence and experience than I in this field. Given my desire not to repeat existing comments or retrace old tracks I will, instead, attempt to map how the lessons from behavioural economics can help us understand competition agency behaviour and perhaps point to some steps we can take to amelio-rate their effects.

Competition agencies are staffed by individuals and if behavioural approaches have taught us anything they have taught us that individuals are subject to decision making biases. Add to this the structure of organisations and the tendency of organisations to create mechanisms that emphasise or undermine these biases I think it is about time we consider what we can take from behavioural economics to help us work better as decision making bodies and communities. I will highlight what I think are the most obvious areas open for further analysis and make some preliminary remarks about what we can and have done to counteract their worst effects.

It must be said at the outset that this discussion is not meant to be a criticism of competition agencies and analysis. However, I contend that we need to think about how normal human decision making biases can have an impact on how agencies behave. We are all human after all!

The most obvious behavioural bias we have to consider is the tendency of people to look for evidence that supports their existing hypothesis; the "confirmation bias" problem. Thus once a decision has been taken to proceed with a case, and thus a 'problem' has been found, it is natural for staff to look for evidence that supports the existence of the problem rather than evi-dence that undermines the existence of a problem. Given that this is a normal human reaction to information processing we need to ensure that mechanisms are in place to allow evidence that undermines an existing hypothesis to be given as much weight as that which supports it. The most serious potential bias in agency decision making, however, comes in a bundle of behavioural factors that I will categorise as The Mastermind Problem. I have named it thus after a famous UK TV quiz show where the question master, if interrupted by the timing bell would state; 'I have started so I will finish'. The duo of behavioural biases that make up this agency challenge come in the form of the sunk cost bias and the momentum bias.

This deadly duo delivers what I fear is an easily recognisable problem in agency decision making; namely that once an agency has invested time and effort in starting a case it is unlikely to stop that investigation even when its value or importance has proven to be less than immediately thought. Probably ever competition lawyer and indeed agency head in this room can think of examples of cases that were carried through to an often bitter end when in all truthfulness they could have been killed off long before. For the sake of keeping a friendly atmosphere and avoiding embarrassment I will not ask anyone for nominations!

The problem posed by the theory of momentum and sunk costs is a very real one, particularly in single process administrative agencies. It is here I would like to sing the praises of both the US and the UK approaches. In both instances the problem of momentum is addressed by a clear break between Phase I and Phase II in investi-gations; in the US case by having to try a case before a court and in the UK case by transferring a case from the OFT to the Competition Commission. Of course, neither system was established with any sense of behavioural economics but its solutions to the problem of 'judge-jury-executioner' in one body stops the problem of momentum in its tracks. I can readily attest to the utility of a 'fresh set of eyes' in an investigation. Such a break severs the link between initial decision and final finding; there is no investment carry over from one body to the next and simply because the Phase I body has found a problem does not mean that the Phase II body will do likewise.

However, simply having a break between Phase I and Phase II does not by itself break entirely the problem of momentum. This is where the peculiar genius of the de-signers of the UK Competition Commission comes into play. It is natural that at staff level the passing of a problem from the OFT to the CC indicates that a 'problem' exists. Those staff are part of a community of officials and experts who regularly interact and discuss issues. This community is more likely to develop some form of 'group think' (another common behavioural problem) than a group that includes people from outside of that community. The design of the Competition Community means that a Panel of independent people are appointed to direct and decide upon cases. These people tend to come from a variety of backgrounds but are rarely over-encumbered with 'group think' biases. This inbuilt panel of independence firmly undermines the tendency of agencies to follow the momentum bias and use group think to ensure sunk costs are not wasted.

Of course, a two stage process may not be ideal for all agency structures. Indeed for many developing country agencies a two-stage process may simply not be affordable, either in pure money terms or in terms of the pool of readily available talent. However, it does highlight the benefits of having a means of breaking the flow of momentum and ensuring that group think does not damage the analytical acuity of our decision making. It has to be recognised that many agencies have also noticed this problem, although probably without recourse to the lessons of behavioural economics. The European Commission in the aftermath of the Airtours judgement set in train a number of reforms to its processes that seeks to limit the impact of momentum, confirmation bias and group think through greater scrutiny of deci-sions in the pipeline. However, it is probably too early to tell whether these reforms have insulated the Commission from decision making problems.

To conclude; I would ask all of those of us that work in the field of competition to spend as much, if not more, time using the lessons of behavioural economics to assess our own decision making processes as we do look-ing at consumers and firms. We must ensure that our own decision biases are recognised and their potential negative impacts minimised. We need to ensure, most of all, that we recognise that we are flawed human beings working in institutions with structural mechanisms that may emphasise behavioural biases. Only with such recognition will the strength come to reform those processes to ensure that we deliver even more effective agencies to the benefit of consumers and the wider society.

Thank you ladies and gentlemen for bearing with a slightly obtuse approach to the lessons from behavioural economics and I look forward to any responses or questions you may have.