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Putting B before AAA

HOW REGULATORS CAN GET THE BEST OUT OF BEHAVIOURAL ECONOMICS

Economic regulators have woken up to the potential of new behavioural techniques. But to realise this to the full, they need to break their own deeply ingrained habit of supposing that consumer decision-taking should always be rational. As well as helping consumers do the three As - access, assess, and act - they need to think B - how consumers actually behave when taking decisions.

Back in 2010, the Office of Fair Trading (OFT) published an influential paper entitled "What does Behavioural Economics mean for Competition Policy?". This introduced the alliterative notion that consumers should be able to "access, assess, act".

The OFT may have disappeared, but the AAA catchphrase certainly caught on. Regulators including the Competition and Markets Authority, the Office of Gas

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and Electricity Markets, the Office of Communications and even the UK regulators' network, UKRN, have either referenced it or been urged to do so. These "ideal triplets" are often described as the consumer's "decision-making process", or even elevated to "mantra" status. But do they really describe how consumers behave? Or do they try to squeeze behavioural economics into the classical framework that assumes consumers behave like machines, merely needing to be given the right fuel to deliver a "rational" outcome?

HIDDEN ASSUMPTIONS

The 2010 OFT paper started with the unexceptionable proposition that "markets work well when there are efficient interactions on both the demand and supply side." So far as consumers are concerned, the paper argued, this means that ideally they need to:

- **access** information about the various offers available in the market;
- **assess** these offers in a well-reasoned way; and,
- **act** on this information and analysis by purchasing the good or service that offers the best value to the customer.

A "virtuous cycle", so the argument continued, was formed when active rational consumers and vigorous competition work together, and so any weak link in the circle could harm the whole. When any of the three elements of the consumer decision-making process broke down, consumers' ability to drive effective competition could be harmed.

But this framework depends on an important - and unstated - assumption: that a rational consumer decision is a realistic goal. Consumer decision-making has been proven time and again to be driven by factors other than (economically) rational motives.

It's important not to get hung up on the definition of rationality. Rational doesn't necessarily mean "best"; results that are not "rationally optimised" should not necessarily be classed as "irrational", with all the negative connotations. Behavioural economics has helped us to recognise that evolution has equipped us with the capacity (and a demonstrable preference) for making quick and adequate decisions as well as cognitively demanding and conscious ones.

These quick decisions may rely on "biases" (another word whose pejorative connotations can get in the way of our understanding of behavioural economics) that help people to take those decisions to which they don't want to devote cognitive effort. And 200,000 years of evolution suggests that we have found it not a bad way of rationing effortful decision-making. Evolution does not mean that our brains are perfectly wired for the modern world, but adopting a regulatory approach based on changing the way the people think may be difficult, if not downright mistaken.

The AAA framework is susceptible to this error. It is built on the recognition that consumers don't always make rational decisions, but then assumes consumers will treat new information rationally. This inconsistency conflicts with observation, and with the rich literature on how (and why) human beings can "rationally" decide to avoid information, even when it's free and independent.[1]

NOT WORTH THE EFFORT?

Most human behaviour is a simple trade-off between effort and reward. Equipped with a finite capacity for conscious effort we routinely (but unconsciously) gauge what is likely to yield the best return for lowest input. Regulatory approaches that ignore the effort side of the trade-off – as AAA tends to do – are in danger of making matters worse, not better. Over the years there has been no shortage of well-meaning attempts by regulators to ensure that customers, before they take decisions, are given information that those regulators think they should be interested in. We only have to look at financial services to see the consequences: too often an onerous purchasing experience that serves to annoy and even alienate consumers instead.

Of course, such realistic conclusions raise other difficult questions, found along the circular path traced out in the OFT's paper. If, as consumers, we typically do not want to make "rational" decisions, how can we hope to have effective markets? And how can regulators do anything to improve the outcomes of our "sub-optimal" decisions?

We can start by observing that while consumers routinely make many kinds of purchasing decisions without referencing any detailed information, the markets in which they do this remain highly competitive. The average household will spend more than £225,000 over a lifetime on food, drink and other domestic products. Choosing where to shop - even between supermarkets - is, at least in theory, a massively complex decision, which should take account of product range, availability, pricing, location, loyalty schemes, promotions, service, quality, in store or online… and yet consumers seem to cope perfectly well.

Some argue that intense competition in the grocery market gives customers the confidence to short-cut information-gathering when making a decision. Or they make the point that groceries are simpler to shop for than - say - a savings account, because consumers have more opportunity to learn good grocery shopping through repeat buying rather than pre-purchase analysis. Fair enough, but not the whole story.

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[1] A good summary is provided in Golman, Hagmann and Lowenstein's "Information Avoidance" in the Journal of Economic Literature 2016 (forthcoming).

Customers may, in fact, have acquired less accurate pricing knowledge about their tuna than their savings account, despite the fact that over a lifetime they could no doubt save hundreds of pounds by swapping tuna brands. In real life, people's grocery-buying simply doesn't follow the decision tree that would satisfy the rationalists.

Consumers' actions are mainly driven first, by what interests them about the product they are buying (which is rarely the same thing as its price), and second, by habit. And if you want to change consumer behaviour you would do better to focus on these drivers, rather than hope for some disclosure-induced rationality to emerge.

FOCUS ON THE WHAT, NOT THE WHY

This understanding creates a dilemma for regulators. Should they try to get consumers to make their decisions for "good" reasons (i.e., follow the rational approach that fits with the regulator's view of what is "right")? Or should they try to change consumers' behaviour without bothering about the reasons (i.e., get them to take what regulators think are the "right" decisions without worrying about how they are persuaded to do so)?

Both approaches, obviously, have their dangers - regulators should be wary of "knowing best", about either reasons or results. But in terms of influencing outcomes, thinking about how consumers actually behave is likely to be more rewarding than constructing ever more complicated models of how they ought to behave. And in particular, thinking about minimising rather than maximising the cognitive effort imposed on the consumer is likely to yield better results. Put simply, the likely success of any initiative is almost always inversely proportionate to the cognitive demands it places on the consumer.

Behavioural economics teaches us that much human behaviour is habitual. If we want to change behaviour, therefore, we are often trying to break a habit. And - as marketing people, psychologists, sports coaches, nutritionists and addiction counsellors have known for years - the best way to do this is often to try to create a new habit.

Take the weight loss industry, where money and science have taken techniques way ahead of the regulators' tool box. A common approach to changing deeply ingrained eating habits is to think about "behaviour chains" and introduce incremental changes to the chain. So, if you want to eat more healthily, you are more likely to achieve success by introducing new and specific behavioural rules (e.g., "I'll eat a carrot every time I think about going to the vending machine") than by trying to re-engineer your whole diet in one go, or by focusing on the desirable but distant outcome of looking like your favourite model. This focus on small behavioural steps gives us an attainable sense of progress.

A related concept is "stimulus-response learning". Think about training a young dog, and how discrete uses of reward can change the dog's behaviour. Those

who want to eat more healthily can try similar mechanisms. Find an existing reward pattern (e.g., eating a biscuit when you've passed the mid-point of your workday afternoon) and replace it with a different reward (watching a YouTube clip). Or take healthy tasks (exercise) and attach rewards (a cinema trip after the gym). This form of stimulus-response learning has been shown to be extremely effective in creating sustainable changes in behaviour.

The focus of these (and other) well-established techniques is on changing specific behaviours; they do not work on the assumption that getting overweight people to study the benefits of being slim will motivate them to change. They are based on the understanding that the effective way to go may be from action to thought - the "behavioural" way - not thought to action - the "rational" way. The causality runs in exactly the opposite direction to AAA.

In trying to ensure that customers access and assess before acting, regulators risk creating barriers to the behaviour they are seeking to encourage. And they are limiting their options. Good behavioural economists would look at ways to bring about the desired behaviour at low cognitive effort, because the success of any initiative is almost always inversely proportionate to the cognitive demands it places on the consumer.

The key to success is to test such initiatives, to discover what most easily reduces those demands. Sometimes, quite small changes seem to help, like altering the colour or font of an email. The Financial Conduct Authority, one of the more creative of the regulators, has successfully rummaged in the behavioural economics toolkit to exploit such ideas.

Altering behaviour by making something easier to read is hardly contentious. A bigger question is how far behavioural techniques should be taken by regulators, or approved of in the market place. Do we only give a big tick to customer switching that is motivated by a careful study of the small print? Or do we give at least half a clap for switching caused by the desire for a fluffy toy?

If we could create switching momentum by incentivising energy customers to swap details about usage and charges, would we care how this was done? What if it were achieved by embedding an energy comparator in Candy Crush, so that players could compare with fellow gamers, in return for extra boosters and lives? Similarly, what if a media campaign fronted by (let's say) Jeremy Clarkson telling customers that claiming for PPI is easier than getting a hot meal at the end of a day's filming? If that worked, would that make it the "right" thing to do?

REVERSING THE MANTRA

The most general lesson for regulators is to go with the flow of human decision-making: think B for behaviour before AAA.

- Look at chains of behaviour and current consumer habits in particular markets, and identify the links you'd like to change. Track back from the

market outcome you'd like to achieve to the specific behaviours required to bring it about

- Look for incremental change in behaviour, which can be supported by reward structures, rather than trying to change everything in one go.
- Do not overload consumers with "disclosure materials" that are more likely to demotivate than motivate; try to give consumers a product understanding that chimes with what they are interested in, rather than focussing blindly on "transparency."
- If you want to stick with the discipline of AAA, look for ways to make access and assess as easy as possible, with minimum cognitive effort (and possibly some immediate reward). Do not assume that the "assess" phase needs to be a fully-formed, entirely rational consideration process.
- Be wary of traditional customer surveys and focus groups that support your assumptions. How people say they take decisions, what they say they need in order to take better ones, and what they actually do, may be rather different. The only way to evaluate an initiative intended to change behaviour is to test whether it does.

ON THE RIGHT TRACK

Here's a concluding story to help change the way you look at behavioural questions. Imagine you own a patch of land which people cross to get from one group of buildings to another. Fairly quickly, a track will have formed revealing the path people choose to take. Suppose that you would like them to take a different path? With the AAA approach you would provide an information board, and a no doubt impressive rationale as to why an alternative route would be preferable. But if the notice is long and detailed, the chances are no one will read it and most will nip across on old track just the same.

So what else could you do? Well, put up a fence, of course - but that wouldn't stop people wanting to take the old track, and hopping over the fence to do so when no one was looking. What could a behavioural economist suggest? Moving the entrance on one of the buildings, perhaps, or putting something really desirable at the midpoint of the route that you would like people to take (a café? a bird-watching hide? a flower bed?). At the very least, a behavioural economist would insist on you trying all sorts of different messages on your board, knowing that how you say it is every bit as important as what you say. And remembering that the ultimate measure of success is not whether people change course for the "right" reasons, but whether they change at all.

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