**Consumer Financial Protection Bureau**
**Behavioral Economics Symposium**
**Panel 2: Behavioral Law & Economics and Consumer Financial Protection**
**Statement of Joshua D. Wright**[1]

## I. Introduction

During my career as an economist and lawyer, I have had the great honor of serving at an independent agency charged with enforcing consumer protection laws – the Federal Trade Commission (FTC) – four separate times. Those experiences, in which I have served as a staff intern, economist, lawyer, and eventually as Commissioner – have emphasized to me the role that economics can play in improving consumer protection enforcement. Indeed, prioritizing independent economic analysis and its integration into its enforcement missions have been critical drivers of the FTC's success.

Robust economic analysis, grounded in testable theories and empirical evidence, can sharpen an agency's existing tools to best serve consumers. Alternatively, when the FTC's enforcement and policy actions have become untethered from economic analysis, the agency has faltered and been the subject of significant criticism. I strongly commend the CFPB for taking a careful approach to formulating its consumer

[1] This statement draws on my prior works: Joshua D. Wright, *The Antitrust/Consumer Protection Paradox: Two Policies at War with Each Other*, 121 YALE L.J. 2216 (2012); Joshua D. Wright & Douglas H. Ginsburg, *Behavioral Law and Economics: Its Origins, Fatal Flaws, and Implications for Liberty*, 106 NW. U. L. REV. 1033 (2012); and Michael R. Baye & Joshua D. Wright, *How to Economize Consumer Protection*, THE ANTITRUST SOURCE, Feb. 2018.

protection policies—including by leveraging the research and knowledge offered by the esteemed group of panelists I have the privilege of participating beside today.

Behavioral economics—like any economic analysis—can be a useful part of the consumer protection toolkit where its insights are robust to careful testing in markets, integrated into legal institutions, and applied to consumers and regulators. Legal scholars' unbridled enthusiasm for insights from the nascent behavioral economics literature have sometimes resulted in premature application with, at times, negative consequences for consumers. Careful empirical testing of economic tools – whether behavioral or "traditional" – are critical to leveraging their use to maximize the rate of return consumer protection agencies can generate for consumers.

## I. Behavioral Economics as a Policy Prescription: An Overview

Behavioral economics—a relatively young field within economics—has captured significant attention in recent years. Essentially, the field combines economics and psychology to produce a body of evidence that individual choice behavior departs from that predicted by neoclassical economics in a number of decisionmaking situations. Departures from rational choice behavior are said to be the result of the individual's "cognitive biases," that is, systematic failures to act in one's own interest because of defects in one's decisionmaking process. For example, an individual might *prefer* to receive $50 than to receive $100 then lose $45 because the individual values losses differently than she values gains.

To date, the documentation of cognitive biases in laboratory experiments has been behavioral economics' primary contribution to microeconomics. These biases, behavioral economists assert, demonstrate systematically irrational choice behavior by individuals and firms. For example, individuals hold investments that decrease in value too long and sell assets that increase in value too quickly. This irrational behavior, in turn, breaks the link between revealed preference and individual welfare upon which neoclassical economic theory depends. A second, relatively nascent yet critical line of research in behavioral economics uses field experiments to test whether the biases documented in laboratory experiments are robust to exposure to markets.[2] Behavioral economists are aware of the need for experiments that isolate and identify biases that persist in market environments as a precondition to regulation.[3]

The "behavioral *law and* economics" (BLE) movement, which explores the legal and policy implications of cognitive biases identified in the behavioral economics literature, quickly followed the diffusion of behavioral economics. The legal academy

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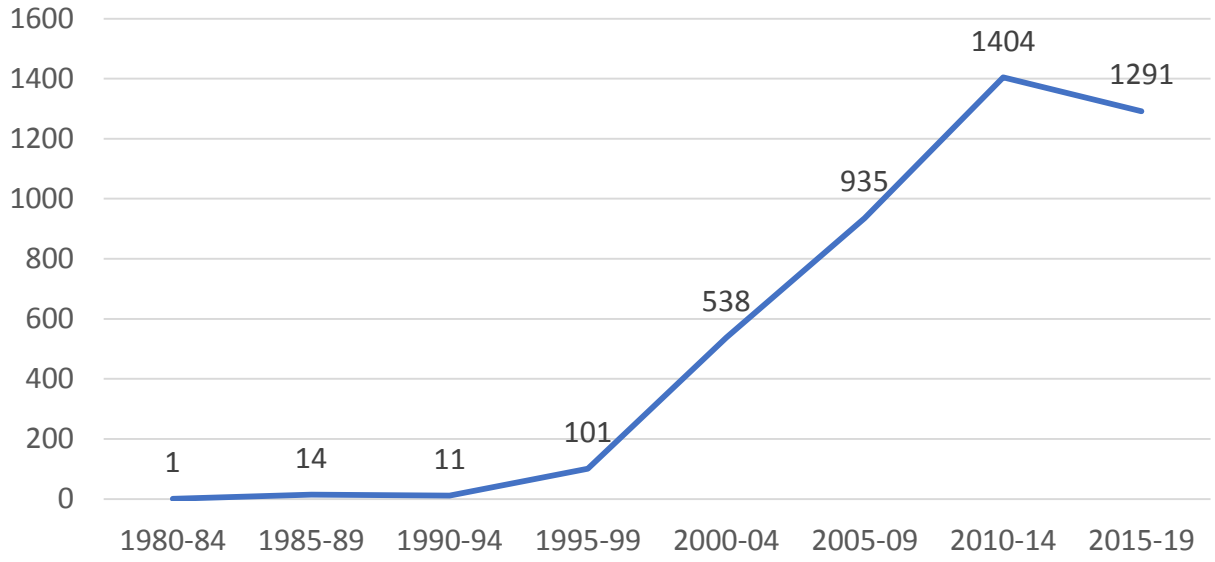
[2] *See, e.g.*, Michael S. Haigh & John A. List, *Do Professional Traders Exhibit Myopic Loss Aversion? An Experimental Analysis*, 60 J. FIN. 523 (2005) (discussing the sensitivity of laboratory results to market environments where competition, expertise, and learning might be expected to ameliorate any biases); Steven D. Levitt et al., *What Happens in the Field Stays in the Field: Exploring Whether Professionals Play Minimax in Laboratory Experiments*, 78 ECONOMETRICA 1413 (2010) (same); John A. List, *Does Market Experience Eliminate Market Anomalies?*, 118 Q.J. ECON. 41 (2003); Uri Gneezy & John A. List, *Putting Behavioral Economics to Work: Testing for Gift Exchange in Labor Markets Using Field Experiments*, 74 ECONOMETRICA 1365 (2006); John A. List et al., *Combining Behavioral Economics and Field Experiments to Reimagine Early Childhood Education*, 2 BEHAVIOURAL PUB. POL'Y 1 (2018).

[3] *See* Steven D. Levitt & John A. List, *Viewpoint: On the Generalizability of Lab Behaviour to the Field*, 40 CANADIAN J. ECON. 347 (2007) (analyzing properties of human behavior that limit the power of inferences drawn from laboratory results in markets). See generally Omar Al-Ubaydli et al., *What Can We Learn From Experiments? Understanding the Threats to the Scalability of Experimental Results*, 107 AM. ECON. R. 282 (2017).

has widely disseminated the body of experimental evidence documenting irrational behavior and is largely responsible for the behaviorists' foothold in regulatory policy circles, both in the United States and overseas.[4]

Figure 1:
References to "Behavior Economics" in Legal Scholarship

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BLE proposals include mandates requiring the supply of more or better information in an attempt to "debias" individual decisionmakers, to alter legal default rules, to imposing "sin" taxes upon products, or in some cases, to ban them.

[4] Colin R. Kuehnhanss, *The Challenges of Behavioural Insights for Effective Policy Design*, 38 POL'Y & SOC'Y 14, 31 (2019) (noting that 51 countries now have centralized BLE initiatives, including Australia, Canada, Denmark, France, Germany, Saudi Arabia and Singapore).

[5] Figure 1 measures that number of times the term "behavioral economics" appears in the Westlaw JLR database in the relevant time period, as of September 9, 2019.

The basic contention underpinning such proposals is that markets, under certain conditions, cater to biases rather than correct them. Indeed, BLE has made significant inroads in consumer financial protection. BLE scholars argue that consumers consistently underestimate their future borrowing due to a host of behavioral biases such as imperfect self-control, hyperbolic discounting, and systematic underestimation of the probability of negative consequences. Rather than viewing "teaser rates," zero annual fees, and rewards programs as signs of intense and healthy competition among credit card issuers, BLE adherents have argued that card issuers design such products and contracts to exploit the behavioral biases of consumers.[6]

The BLE movement typically calls for government intervention to correct allegedly irrational decisionmaking as observed in experiments, pledging to better align individuals' actual choices with their "true" preferences. The relevant question is how confident we can be that a regulator with the power to intervene based upon behavioral

[6] *E.g.*, MICHAEL S. BARR ET AL., BEHAVIORALLY INFORMED FINANCIAL SERVICES REGULATION 12 (2008) ("Credit card companies have fine-tuned product offerings and disclosures in a manner that appears to be systematically designed to prey on common psychological biases—biases that limit consumer ability to make rational choices regarding credit card borrowing."); Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 46–52 (2008) (providing examples of numerous product design features that can be used to exploit consumer biases); Elizabeth Warren, *Redesigning Regulation: A Case Study from the Consumer Credit Market*, *in* GOVERNMENT AND MARKETS: TOWARD A NEW THEORY OF REGULATION 391, 391 (Edward J. Balleisen & David A. Moss eds., 2010) ("Businesses have learned to exploit customers' systematic cognitive errors, selling complex credit products that are loaded with tricks and traps.").

approaches will improve matters. Indeed, there are countless academic articles exploring the unintended, welfare-reducing effects of regulation.[7]

There are a number of reasons one might be skeptical of the behavioral regulation mission. Even the most well-intentioned and competent regulators are only capable of knowing people's preferences at the margin, and regulatory action by definition affects all consumers. Moreover, in order for markets to be efficient, individuals must be free to learn.[8] Using regulation to reduce the costs of individual errors runs the risk of dampening the incentive to learn from mistakes over time.[9] Finally, individual policy interventions can be evaluated from an economic perspective.

None of this is to say that behavioral economics provides no value to institutions designed to protect consumers or that its insights should be ignored. For example, behavioral economics might be a useful tool in say, public administration. Indeed, the tax authorities in the US and UK have already been experimenting with how insights from behavioral economics may assist in improving collection rates (e.g., by changing the language on collection notices). One recent study supports a theory of self-signaling

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[7] For just one recent example, see the recent Department of Justice "Roundtable on Anticompetitive Regulations" and attendant submissions (May 31, 2018), https://www.justice.gov/atr/roundtable-anticompetitive-regulations-thursday-may-31-2018.

[8] *See, e.g.*, Jonathan Klick & Gregory Mitchell, *Government Regulation of Irrationality: Moral and Cognitive Hazards*, 90 MINN. L. REV. 1620 (2006).

[9] For example, a commonly invoked example of consumers' irrationality is that financial intermediation constitutes a relatively significant portion of GDP, notwithstanding that index funds require less work and tend to provide higher returns on average. While there are a number of data-oriented critiques that effectively rebut this claim, it is also useful to consider the effects of adopting the logic. If everyone moved to index funds, there would be no incentives for robust equity research, leading to a drop in market information and transparency.

and finds that ego utility can be a determinant of consumer choices in certain contexts.[10] In terms of "nudging" prosocial behavior, this study suggests that product discounts and donations are not inherently complementary. In the consumer protection context, empirical studies of consumer perception inform disclosure design and to identify potential deception.

## II. Neoclassical vs. Behavioral Economics

To understand how behavioral economics differs from neoclassical economics, one must carefully distinguish rational errors (i.e., efficient mistakes) from truly irrational behavior. Neoclassical economics and price theory are built on the foundational assumption that individuals and firms are rational maximizers. A rational actor makes choices that maximize her utility function subject to the constraints that she faces, including imperfect information, based on a set of stable, well-defined preferences. The traditional price-theoretic framework allows for efficient mistakes because rational actors economize on both information and transaction costs. In short, not all errors imply irrationality because efficient decisionmaking can be costly. The great strength of the neoclassical approach is that it allows economists to rely on observed choices to infer preferences and make statements about consumer welfare—the idea of revealed preference.

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[10] Jean-Pierre Dube et al., *Self-Signaling and Prosocial Behavior: A Cause Marketing Experiment* (Fox School of Business Research Paper No. 15-079) (2015), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2635808.

Behavioral economics promises economics with greater explanatory power, and perhaps more powerful implications for using law to enhance economic efficiency and make individuals better off, by breaking the link between individual decisionmaking and welfare. That is, by rejecting revealed preference.[11] Specifically, behavioral economics asserts, based upon insights from psychology, that decisionmakers make systematic departures from rational choice behavior due to cognitive biases. These include optimism bias, loss aversion, present bias, and limited self-control. The behavioral economics research program has thus far focused largely upon an effort to demonstrate experimentally circumstances in which economic decisionmakers appear systematically to depart from rational choice behavior based on these biases.

Experimental findings of cognitive biases, while interesting, are not necessarily useful for policy purposes. Thus far, behavioral economists have not created a theoretical mapping of the real-world conditions under which individual decisions will be fettered by cognitive biases and when they will not.[12] A significant concern for policy applications is that biases documented in experimental settings may not prove robust when exposed to market institutions.[13] Irrational behavior that appears in experiments sometimes disappears when exposed to market discipline and the profit

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[11] *See* Colin F. Camerer & George Loewenstein, *Behavioral Economics: Past, Present, Future*, *in* ADVANCES IN BEHAVIORAL ECONOMICS (Colin F. Camerer et al. eds., 2004).

[12] See Matthew Rabin, *Incorporating Limited Rationality into Economics*, 51 J. ECON. LIT. 528 (2013) (discussing difficulties and setbacks in creating widely applicable behavioral economic models).

[13] *See generally* Steven D. Levitt & John A. List, *Viewpoint: On the Generalizability of Lab Behaviour to the Field*, 40 CANADIAN J. ECON. 347 (2007) (analyzing properties of human behavior that limit the power of inferences drawn from laboratory results in markets).

motive, which create incentives for participants to specialize and to learn to reduce their errors.[14] To support policy intervention, behavioral experiments must yield data that are robust, and be interpreted carefully to distinguish irrational behavior from efficient mistakes.

## III. Behavioral Law and Economics

The quest to translate the insights of behavioral economics into public policies intended to improve decisionmaking and welfare has achieved a remarkable degree of momentum. In their best-selling book *Nudge*, Cass Sunstein and Richard Thaler popularized the term "libertarian paternalism" to describe legal interventions that both (1) increase the individual's economic welfare by freeing her from the limitations of her cognitive biases, and (2) change the individual's behavior without limiting her choices.[15] They suggest that governments accomplish this through the use of "nudges," which they define as any action that "alters people's behavior in a predictable way without forbidding any options or significantly changing their economic incentives."[16] The hope is to push individuals to act in accordance with their "true preferences," the set of preferences they would hold if freed from cognitive bias.

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[14] See Edward L. Glaeser, *Paternalism and Psychology*, 73 U. CHI. L. REV. 133, 140 (2006) ("In experiments, individuals have few tools with which to improve their reasoning, and their only real method of responding to incentives is to think harder.").

[15] RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS 9-10 (2008).

[16] *Id.*

The forms that nudges and other BLE regulatory proposals take run the gamut from gentle attempts to encourage retirement savings to outright bans of certain products. Some proposals would modify legal default rules; others seek to manipulate framing effects. Some behaviorist proposals do not directly restrict the set of choices available to consumers but impose a cooling-off period or some other burden placed upon producers that, in turn, results in higher prices, reduced variety, or both. Since *Nudge*'s publication over a decade ago, governments around the world have begun implementing these ideas.

The lack of a comprehensive behavioral theory of irrationality, however, makes it inevitable that behavioral interventions will lead to policy errors. The inevitability of policy errors derives from the insurmountable theoretical and empirical obstacles to identifying any one person's, let alone the distribution of all persons', true preferences. One type of policy error will occur when a behavioral intervention is aimed at seemingly irrational behavior that is in fact rational for the decisionmaker in question. In other words, the social costs of this type of policy error flow from encouraging behavior the paternalist inaccurately believes will make individuals better off and concomitantly discouraging acts that satisfy their actual preferences. A second type of policy error will occur when an intervention designed to improve the decisionmaking of truly irrational economic agents imposes costs, as it inevitably will, upon all those who are not irrational and for whom the same decision is not an error. In this case, it is

erroneous beliefs about the distribution of true preferences that lead to the policy error. Finally, because behavioral economics generates indeterminate predictions in many settings,[17] regulators have myriad opportunities to substitute their preferences for those of the public. Any rigorous evaluation of the costs and benefits of behavioral intervention must account for the potential abuse or simply mistaken use of behavioral economics by regulators.[18]

These policy errors are not hypothetical; examples of nudges backfiring in the real world have already been documented. For example, Mexico attempted to nudge its citizens to choose lower-fee social security plans by creating an official fee index for citizens to use in selecting a plan.[19] Economists found that the nudge induced firms to shift their fee structures to lower their index values while raising total costs.[20] The net effect of the index was higher revenues for firms and redistribution from low-income to high-income consumers.[21] Another example comes from the Making Work Pay income tax credit, intended as a fiscal stimulus during the financial crisis. Behavioral economists predicted that giving the credit as a slow and recurring decrease in withholding, rather than a lump sum reduction like the one given the previous year,

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[17] *See* Todd J. Zywicki et al., *Behavioral Economics Goes to Court: The Fundamental Flaws in the Behavioral Law & Economics Arguments Against No-Surcharge Laws*, 82 MO. L. REV. 769 (2017) (documenting behavioral arguments both for and against no-surcharge laws).

[18] Consider that regulators are unable to observe and correct their own behavioral biases, such as a tendency to overestimate the ability to improve market outcomes.

[19] Fabian Duarte & Justine S. Hastings, *Fettered Consumers and Sophisticated Firms: Evidence from Mexico's Privatized Social Security Market* (Nat'l Bureau of Econ. Research, Working Paper No. 18582, 2012).

[20] *Id.*

[21] *Id.*

would be more likely to stimulate spending.[22] However, survey data showed that only 13% of households reported they would increase spending in response to the lower withholding, versus 25% of households that reported they would increase spending in response to the prior year's lump sum tax cut.[23]

Because regulators are human beings, subject to the same cognitive biases as the regulated parties and possessing imperfect information, mistakes like these are an ever-present danger. To be sure, the incentive structure for regulators is likely to reward those who adopt politically expedient policies. A regulator is likely to pursue a policy that accounts for the rewards she receives from her political supervisor. The political supervisor's optimal policy is frequently one that maximizes short-run outputs and political support, rather than long-term welfare outcomes. In this regard, BLE insights may be particularly useful in helping us to think about how to de-bias regulators through the design of regulatory institutions.[24]

## IV. The Behavioral Approach to Consumer Financial Protection

Consumer protection law has traditionally aimed to protect consumer welfare, and in turn, consumer choices, from business practices that would diminish it. The Supreme Court has long described the link between consumer preferences and

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[22] Claudia R. Sahm et al., *Check in the Mail or More in the Paycheck: Does the Effectiveness of Fiscal Stimulus Depend On How It Is Delivered?*, (Nat'l Bureau of Econ. Research, Working Paper No. 16246, 2010).
[23] *Id.*
[24] James C. Cooper & William E. Kovacic, *Behavioral Economics: Implications for Regulatory Behavior*, 41 J. REGULATORY ECON. 41 (2012).

consumer welfare in the context of consumer protection law in near absolute terms: "The consumer is prejudiced if upon giving an order for one thing, he is supplied with something else. In such matters, the public is entitled to get what it chooses, though the choice may be dictated by caprice or by fashion or perhaps by ignorance."[25]

Behavioral economics provides the intellectual foundation for a revolutionary departure from this traditional assumption of consumer protection that actual choice behaviors reveal evidence of welfare. Rather than making this assumption, the BLE approach involves the comparison of actual choices that consumers made with hypothetical choices that they would have made if they were freed from cognitive biases.

This carries drastic policy implications; with the narrowing or abolition of the presumption that consumer welfare can be inferred through revealed preferences, behaviorally informed legal scholarship and policies necessitate some external, third-party validation of welfare-maximizing choices.[26] No longer can expanding consumers' choice set be assumed to improve consumer outcomes.[27] To the contrary, entry of new products and services is suspect under the BLE approach. One tenet of the new behavioral approach to regulating consumer credit is that rules and regulations can be designed to improve consumers' decisionmaking abilities by altering the *design* of some

[25] FTC v. Algoma Lumber Co., 291 U.S. 67, 78 (1934).
[26] *See* THALER & SUNSTEIN, *supra* note 8, at 18.
[27] *See* Cass R. Sunstein, *Forcing People to Choose is Paternalistic*, 82 MO. L. REV. 643 (2017).

consumer credit products, by restricting consumers' access to others, and by instituting default rules in favor of standardized products approved by regulators. The behavioral approach to consumer financial protection also inverts the economic logic that short-term price reductions (such as teaser rates on credit cards) increase consumer welfare, arguing that these short-term discounts exploit irrational consumers' biases and, despite consumers' revealed preferences for the discounted products and services, make them worse off.[28]

In the consumer protection context, as in other contexts, the risks of policy error are high. Those advocating a behavioral approach to consumer financial protection tend to underestimate the costs of implementing proposed policies. Restrictions on the availability of financial products lead to easily measurable losses to consumer welfare as revealed by consumer choices, among other costs. Though advocates may justify these losses by claiming they benefit consumers according to their true preferences, behavioral economics does not yet supply a sure guide to determining what those true preferences are. Untethered from consumer protection's traditional reliance on revealed preference, regulators run risk impinging on consumer sovereignty and substituting their own preferences for those of consumers.

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[28] *See* Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U. L. REV. 1373 (2004). *But see* Joshua D. Wright, *Behavioral Law and Economics, Paternalism, and Consumer Contracts: An Empirical Perspective*, 2 N.Y.U. J.L. & LIBERTY 470 (2007) (surveying empirical evidence to assess claims in the BLE literature involving exploitation of consumer biases with credit cards, standard form contracts, and shelf space contracts; concluding that empirical studies of firm and consumer behavior in each of those examples do not support the claims that BLE generates greater predictive power than conventional price theory).

The assumptions underlying many behavioral interventions in consumer financial protection have been called into doubt. Consider payday loans. Critics charge that these short-term, high interest loans prey on consumers' optimism bias, and suggest regulation as the cure.[29] However, an empirical study on consumers of payday loans found that they are usually well informed about the costs of the services, and hold surprisingly accurate beliefs about their future repayment behavior.[30] Similar examples abound.[31] For this reason, it would be unwise for consumer protection authorities to abandon the solid ground of consumer welfare for the uncertain waters of the behavioral approach.

## V. The Role of Economics in Consumer Financial Protection

There is extreme heterogeneity in consumers' preferences, as well as their rationality. Identification of allegedly common decisionmaking heuristics (i.e., cognitive biases) by no means suggests a market failure in need of government correction. When or how these cognitive biases affect real-world decision making remains unsolved. Consumer protection requires a case-by-case, evidence-based approach. The first step is identifying the *specific* business practice that *harms*

[29] The Pew Institute, Payday Lending in America: How Borrowers Choose and Repay Payday Loans 19 (2013), https://www.pewtrusts.org/-/media/assets/2013/02/20/pew_choosing_borrowing_payday_feb2013-(1).pdf ("Borrowers hold unrealistic expectations about payday loans.").
[30] Ronald J. Mann, *Testing the Optimism of Payday Loan Borrowers*, 21 SUP. CT. ECON. REV. 105 (2014).
[31] See Zywicki et al., *supra* note 10, at 783-84 and sources in footnotes.

consumers. This requires determining whether consumers would have made the same decisions in a "but-for" world with better information.

Developments in behavioral economics remain nascent, and their application to consumer protection is likely premature. Instead of turning to this relatively young field, consumer protection agencies would do well to more deeply integrate traditional economic thinking into their analyses. Economics can be used in consumer protection matters to help prove or disprove a claim that a business practice adversely impacted consumers, and to shed light on the economic merits of litigating versus settling cases. In my experience, many seemingly benign consumer protection settlements induce asymmetries in the marketplace that put the settling firm at a competitive disadvantage. Regardless of whether one's goal is to protect consumers or defend one's client, doing so requires accounting for these effects. More broadly, economics provides tools which, when properly utilized, can help improve the allocation of scarce resources—at agencies and beyond—to better serve and protect consumers.