

CONSUMER SOVEREIGNTY IN AN AGE OF REPUBLICANISM

Ruby Hutchison Memorial Lecture, Sydney, Monday, June 6, 2011

Ross Gittins, Economics Editor, The Sydney Morning Herald

Website: rossgittins.com

I'm honoured to be invited to deliver the Ruby Hutchison Memorial Lecture. I want to talk about consumer sovereignty, in a couple of senses. Conventional economists believe the consumer is king - and should be king. Keynes said that 'consumption - to repeat the obvious - is the sole end and objective of all economic activity'. Production, in other words, is not an end in itself, but merely a means to an end, that end being consumption. It follows that, in regulating the economy, governments ought always to favour the interests of consumers over the interests of producers. And, indeed, the founder of modern economics, Adam Smith, said as much in a famous quote: 'consumption is the sole end and purpose of all production and the welfare of the producer ought to be attended to, only so far as it may be necessary for promoting that of the consumer'. Takeaway message: get your priorities right, the interests of the consumer come first. And if you think I'm reading too much into that quote, try this one - equally famous: 'People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices.'

In another, narrower sense, consumer sovereignty is an assertion that, in a well-functioning market economy, the consumer is king: consumers, not producers, determine exactly what producers produce and in what quantities. Why? Because consumers seek to maximise their utility, while producers seek to maximise their profits, and the only way for producers to maximise their profits is to produce exactly what consumers, in their efforts to maximise their utility, choose to consume. There is a large element of truth in this proposition. You do go bankrupt if you produce things no one wants to buy. And we know that, each year, manufacturers bring on to the market a large number of new products in the hope of catching the consumer's fancy, only to abandon many of them when it's discovered they aren't particularly popular.

Even so, we know that, in practice, consumers don't get it all their own way. They often face a fairly narrow choice. There may be a range of producers in a particular field, but they each produce a remarkably similar product, thus rendering the choice more apparent than real. While in the textbook ideal producers between them make sure every niche is covered, in practice competition can have the perverse effect of causing rival firms to offer the same product. In the classic case of two ice cream sellers on a beach, assuming you have an oblong beach with bathers spread roughly evenly over the area, the ideal place for the two sellers is at the quarter and three-quarter marks, thus ensuring that no bather has to walk more than a quarter of the length of the beach to get an ice cream. But human nature doesn't work the way the model assumes and the two sellers usually position themselves, in the classic phrase, 'back-to-back in the middle of the beach'. Why? Because in their competitive zeal, producers don't focus on the convenience of the customers, but rather on the performance of their competitors. And whereas the model tells us firms will seek to beat their

competitors, in practice their highest priority is, rather, not to be beaten by them. If so, there'll be a strong tendency for firms to offer the same products at the same locations.

The notion of consumer sovereignty comes from the model of 'perfect competition' - a collection of assumptions about how markets work that's a kind of textbook ideal which has never existed or even been approximated in real life. One of its many assumptions is 'atomistic competition' - so many, small firms in a market that no individual firm has the power to influence the price. This notion may have been less unrealistic at the time when economists were formalising this model, in the second half of the 19th century. Today, however, most markets are characterised by oligopoly - a small number of very big firms. Why? Because that's where more than a century of seeking and exploiting economies of scale has left us. The unending search for scale economies is no bad thing: it's one of the primary reasons we're so much more prosperous today than we were a century ago, with the lion's share of those savings flowing to the consumer in the form of lower prices in real terms. There is, however, a price to be paid for having a smaller number of firms producing on much higher scales: those firms acquire a degree of market power. They're more easily able to engage in non-price forms of competition, they're more likely to offer a very similar range of products and they're able to offer their goods and services on terms and conditions that suit their own purposes. Were we ever actually to read the fine print of the contracts we sign we'd discover them to be extraordinarily one-sided, written by lawyers whose only goal is to protect their client from every adverse eventuality. You and I know full well that, were we to say we were prepared to buy the product provided they struck out clause C on page five, we'd be told to take it or leave it. That being so, it's actually rational not to waste time reading the fine print. And here we see why consumers need the protection of common law and consumer law to even up the bargaining power.

One of the assumptions of perfect competition is 'perfect knowledge' - both the buyer and the seller know all they need to know about the nature of the product, its quality and the full range of prices being offered by other sellers. In truth, of course, knowledge is always far from perfect, and is usually asymmetric - one side (the seller) usually knows far more than the other (the buyer). This asymmetry arises because the sellers are professional, whereas the buyers are amateur. I sell fridges for a living, so it pays me to know all about them, including the quality of particular models and the range of prices my competitors are charging; you buy a fridge only once every 10 years, so you wouldn't know much about fridges and it wouldn't make sense for you to know as much about them as I do. The model assumes information is costless whereas, in reality, gathering information can be costly in time and money. This means it's often not rational for consumers to gather all the knowledge they need to live up to the economists' injunction of 'caveat emptor' (let the buyer beware).

Finally, another reason the consumer isn't king is our susceptibility to the blandishments of advertising. I can't remember ever meeting an economist who disapproved of advertising, but that's because it suits economists to assume the role of advertising is purely informational: merely to inform potential customers of the availability, characteristics and price of their product. In truth, blind Freddy knows the primary purpose of advertising is to persuade us to buy things by playing on our emotions and delusions. Often we end up buying things we don't really want.

So far, I've outlined what you might call the conventional weaknesses in the proposition that the consumer is king. But over the past 20 or 30 years a branch of economics called behavioural economics has been studying all the unconventional weaknesses in the conventional model. It's a study of all the respects in which the bedrock assumption of neo-classical economics is wrong. This is the assumption that we're 'rational' - coldly calculating and self-interested in all the decisions we make. Behavioural economics draws heavily on cognitive psychology and neuroscience. It's the systematic study of things marketers understand intuitively. Many of its findings turn on the fact that humans simply don't have the neural processing power to think through all the thousands of decisions we make each day, weighing all the pros and cons. A huge proportion of the decisions we make - even the decisions we make in shops about which one to buy - are instinctive and unconscious. Often we don't know why we jumped the way we did, though our brains are adept at articulating plausible after-the-fact explanations of why we did.

We're not good at assessing the strengths and weaknesses of more than two things at a time, which makes it easy for salespeople to manipulate our choices. Economists assume the wider the range of items to choose from the better off we are. Choice is obviously a good thing - but only up to a point. Studies show that where the choice is too wide people find it hard to make up their mind and often avoid making a decision. Another finding is that we're quite bad at predicting how we'll feel about the actions we take. We tend to expect nice things to give us more satisfaction than they do, while expecting bad things to be worse than they are. This says we often suffer 'buyer's remorse'. The economists' model assumes we know a lot about the quality of the things we buy and this knowledge is reflected in the prices we're prepared to pay. It turns out that, often, we don't know much about the quality of what we're buying and simply work on the assumption that the higher the price we pay the better the quality must be. So the model assumes our knowledge of quality determines the price, whereas in reality it's often the reverse: the price determines our perception of quality. This makes us susceptible to manipulation by marketers - often they can actually sell more of something (cosmetics, for example) by charging a higher price for it.

It's because we often know little about the quality of what we're buying that brands are so powerful: they act as a guarantee of quality, consistency, reliability and refunds where goods prove unsatisfactory. Firms work hard to preserve the value of their brands by making sure they don't disappoint their customers. But brands give firms market power, allowing them to charge higher prices than they otherwise could. Too often, too many of us become too reliant on brands - too often reluctant to try the no-frills product (which in some cases may be identical to the branded product). This reluctance adds to the brand-owner's pricing power. Another aspect of branding is that people often buy prestigious brands as a sign of their success and superior status. This explains why the cost of an Alfa Romeo in Australia compared with in Italy can't be explained by freight costs and differences in taxes etc. It's possible that, were the Australian distributors of Alfas to cut their prices they'd sell fewer cars. Is it a bad thing for firms to charge a high premium for selling status symbols? In a sense, it's what the customer wants. It also raises questions about whether the pursuit of economic growth, and the elevation of consumption above all else, is a particularly worthy objective. If our growing affluence merely allows us to devote more of our incomes to the purchase of 'positional goods' (goods that demonstrate our superior position in the pecking order) - a zero-sum game if ever there was one - how is this game socially beneficial?

It turns out that the way we react to propositions (including sales propositions) is heavily influenced by the way they're presented to us - the way they're 'framed' as the psychologists put it; by the context in which they're put. This explains the literal importance of packaging, and much else. Studies have shown people react very differently to propositions which, when you examine them carefully, are actually identical. This aspect of the way our brains work also creates obvious scope for marketers to manipulate our choices.

There's much more I could say about the findings of behavioural economics, but I'll limit myself to one more issue: self-control. Because so many of our decisions are instinctive and unconscious, all humans have problems with self-control: we're always finding ourselves doing things that, in our cooler, more reflective moments we know we shouldn't do. We have problems controlling our consumption: how much TV we watch, how much we eat, how much we drink, how much we smoke, how much we spend on the pokies, how much we put on our credit cards, how little we save. This is a big issue, to which I'll return.

But that's enough about why the economists' model of consumer sovereignty isn't working as it's supposed to. Now let's turn to why the political model often doesn't put the interests of consumers first, either. In theory, since our democracy is organised on the basis of one adult consumer, one vote, you'd expect politicians always to put the consumers' interests first. In practice, however, governments frequently put the interests of producers ahead of consumers, making life easier for producers by raising the prices faced by consumers. Why does this happen? One very basic and powerful reason is that producers usually have a lot more skin in the game, so it makes sense for them to fight harder than consumers do. Some measure to reduce the degree of competition in an industry may offer considerable benefit to a relatively small number of producers, while increasing the prices paid by each of the huge number of consumers by just a little. Similarly, some reform aimed at increasing competition and thus reducing excessive profits and prices threatens to hit the small number of producers much harder than it would benefit each of the huge number of consumers. The information asymmetry comes into play: producers are far better informed about how they would be affected than consumers are, since the issue lodges far lower in the hierarchy of a consumer's many concerns. Thus producer lobbies find it much easier to organise and raise funds for a campaign for or against some measure than consumer organisations do.

Even so, it remains true that consumers have far more votes than big business does, and politicians care ultimately about votes. This is why the main tactic used by producer lobby groups is to persuade consumers to change sides and back their campaigns, to convince consumers it's they, rather than the producers, who stand to lose most from the measure. Often, this is achieved by slick advertising campaigns. 'This measure would involve huge costs, all of which would be passed on to customers. I'm not worried for myself, just for my customers.' (In which case, why are you fighting so hard?) Many voters know little about how economies work, so when business people tell them some measure (the resource super-profits, for instance) would wreak havoc on the economy and cost a lot of TV viewers their jobs, they're inclined to be believed.

Industry lobbies often start by exaggerating the risk that their own employees will lose their jobs, so unions often join with employers in supporting measures that would reduce the competition in an industry or in opposing measures that would increase competition. This is where it has to be

acknowledged that many consumers are also producers - in the sense that they earn their living working for particular industries. People probably pay more attention and are easier to mobilise when wearing their producer hat than their consumer hat. And politicians are no doubt aware that a threat to a voter's job will be taken by that voter a lot more seriously than a modest threat - or benefit - to their pocket. In the effort to turn consumers into defenders of producers' interests, no one does it better than the doctors: with any threat to their remuneration - such as the Rudd government's abandoned attempt to cut the Medicare rebates paid to ophthalmologists' for eye operations, following technological advances that made surgery much easier and faster - all they have to do is wind up their patients and send them out to do battle with the polities.

All these are the reasons the political model isn't advancing the interests of consumers the way it ought to. So what can we do about it? My first suggestion is that those charged with protecting the interests of consumers, and those who advocate on behalf of consumers, be bolder in their willingness to propose intervention in the market. We live in an age where the rise of economic rationalism and the politically-driven libertarian think tanks has made intervention unfashionable and put consumer advocates much more on the defensive. But as we've seen, the conventional case for the existence of significant areas of market failure remains strong. In this ever-more busy and complex world, it's simply idle to merely warn consumers to beware. Government intervention is often justified to help consumers overcome the extreme information asymmetry and to even up the wide gap between producers' and individual consumers' bargaining power.

Further, the case for intervention is greatly strengthened by the more recent evidence provided by behavioural economics. The rationalists' case against intervention rests heavily on the assumption that consumers are rational, but the evidence of hard science shows us how laughable that assumption is. If consumers really were rational - if we really were able to think like Albert Einstein, store as much memory as IBM's Big Blue and exercise the willpower of Mahatma Gandhi - it wouldn't even be necessary to warn buyers to beware. A favourite chant of economic rationalists and libertarians is to assert that 'no government could possibly know better than I do what's in my own best interests'. If all of us were rational, this assertion would be perfectly true. Since all of us are far from rational, there are likely to be many circumstances in which governments are able to see our best interests more clearly than we do.

As we've seen, fallible humans often have serious problems achieving self-control: in the heat of the moment we often have difficulty making ourselves do what, in our cooler moments, we know we should do in our own, longer-term interests. Our main tactic in seeking to achieve self-control is to use pre-commitment devices. There is much scope for governments to help us with this. The libertarians are always disparaging the 'nanny state', but the truth is many of the interventions and prohibitions governments impose to help us with our self-control are quite uncontroversial and have been introduced with remarkably limited public resistance. Think of compulsory seat-belts and random breath-testing; think of the tight regulation of the advertising and sale of alcohol and tobacco. Think of the ready acceptance of smoking bans in the workplace, buildings and even pubs. Deregulation in any of these areas is unthinkable. Now the Productivity Commission has drawn heavily on behavioural economics with its proposal for compulsory pre-commitment for gamblers.

One consequence of the rise of economic rationalism is the attempt to limit pro-consumer interventions to the provision of disclosure statements and more information on labels. This approach assumes we would be rational if only we had a bit more information. But the findings of behavioural economics show just how laughably inadequate it is. So consumer guardians and consumer advocates need to be bolder in proposing intervention to protect consumers. At the same time, however, they do need to be more considered and inventive in the types of intervention they advocate. One point the rationalists have sustained is that much intervention is ill-considered, ineffective, has unintended consequences and loopholes, or ends up being captured and subverted by producers. Successful intervention is a tricky business. Intervention is likely to be more successful where it draws on the lessons of behavioural economics. Two good examples are the Productivity Commission's gambling reforms and the Cooper committee's proposals for the reform of compulsory super.

My second suggestion is the need for greater economic literacy on the part of consumer advocates. If proposals for new interventions are to get past Treasury they need to be argued rigorously on economic grounds and it's not enough merely to repeat the words 'market failure' as if they were a magic incantation. More to the point, if consumer advocates were more confident in their economic understanding, they'd be more confident in taking a public stand against producers on the make. Why, for instance didn't consumer advocates have more to say when dairy farmers were claiming the supermarket chains' discounting of milk prices would be of no lasting benefit to consumers? Why, when governments take on powerful producer interests - such as the casinos, pubs and clubs - aren't consumer advocates more vocal? Aren't gambling addicts considered to be put-upon consumers? Why when people bemoan the high cost of bananas following Queensland cyclones don't consumer advocates point out that prices shoot up because of the long-standing ban on the importation of bananas to protect the incomes of local banana-growers? If politicians could be more confident of vocal support from consumer groups, they would be more willing to take on producer interests.

My final thought is more in the nature of a prediction. The internet and e-commerce are in the process of revolutionising the consumer experience. The internet has greatly reduced the cost of information gathering and comparison shopping, and will in the next decade or so break down international price discrimination and parallel import restrictions, making the generally much lower prices charged for goods in America available to consumers in Australia. In time this will exert considerable downward pressure on Australian retail prices and enforce much painful rationalisation on retailers, their employees and their landlords.

Because the internet is so impersonal a medium and because it makes price discovery so cheap and easy, it's likely to intensify price competition at the expense of the non-price competition via marketing that oligopolists much prefer, paradoxically making the real world work more the way the economists' model always assumed it did.