AGENDA

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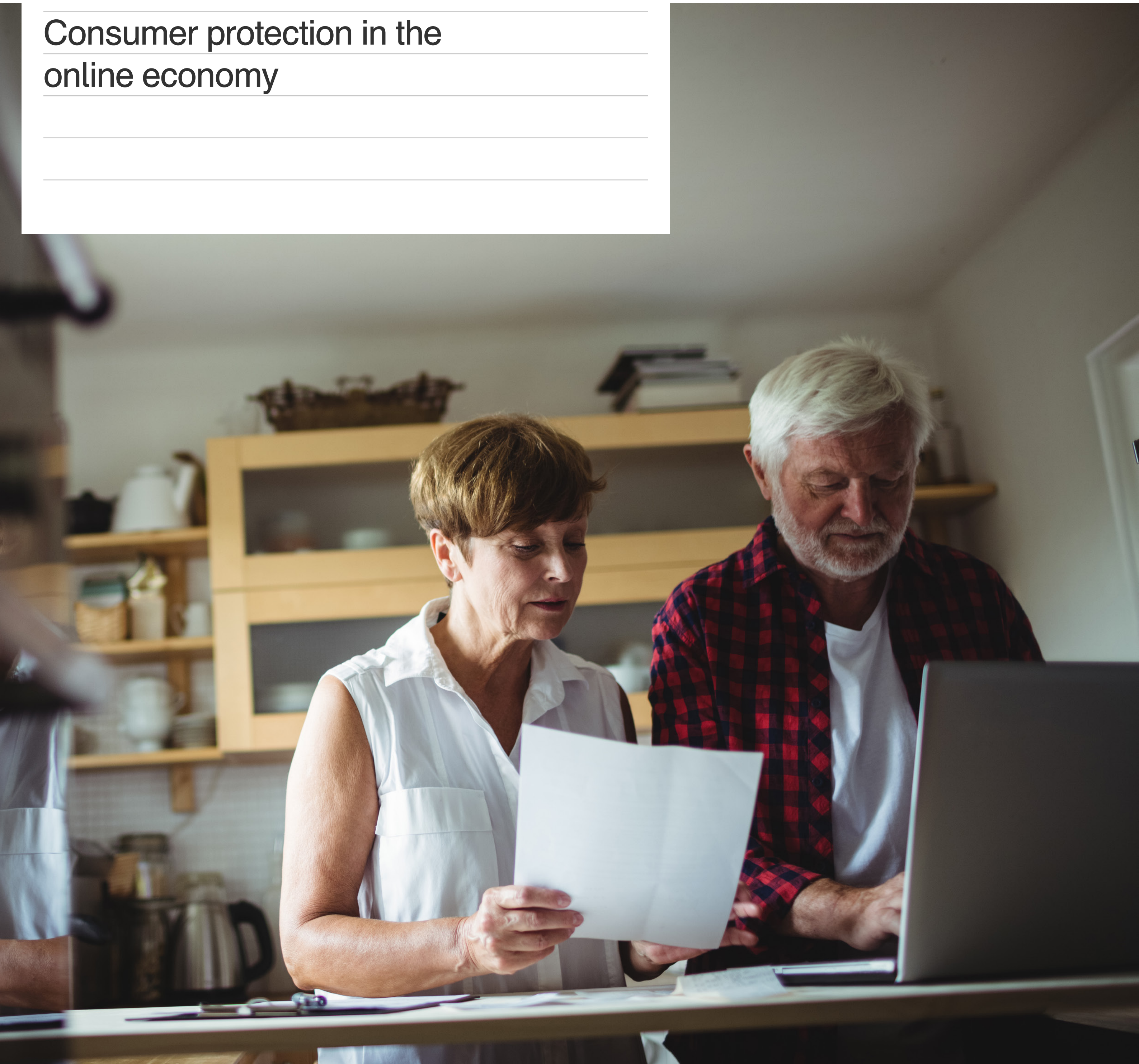
Consumer protection in the online economy



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The Netherlands Authority for Consumers and Markets (Autoriteit Consument en Markt, ACM) has recently published guidelines for online firms and other interested parties, indicating its view on which online business practices are allowed within the boundaries of consumer protection laws—and which are not. Annemieke Tuinstra, Senior Economist in ACM's Chief Economist Team, discusses the economic and psychological concepts behind the guidelines

The ACM's 'Guidelines for the protection of the online consumer' were published on 11 February 2020.[1] The main reason why they had become necessary was the increasing digitalisation of the economy, and the accompanying myriad ways in which firms can influence consumers' online search and purchasing behaviour. Examples include dynamic pricing and 'hypernudging',[2] whereby the online choice environment for different consumers is adapted in real time to stimulate more sales, based on extensive data collection on online consumer behaviour. Many of these influencing mechanisms are not explicitly mentioned in existing consumer laws in the Netherlands, but fall within the realm of the various principles and norms that those laws contain.

The ACM's guidelines explain how the regulator interprets these principles and norms in its enforcement of consumer laws in online markets. This article discusses the economic and psychological concepts that underlie the guidelines.

Asymmetric information and bounded rationality

Consumer search revolves around information. The economics literature in this area has traditionally focused on the role of asymmetric information in the market, and how this can result in higher search costs and fewer informed consumers.[3] In earlier papers, search costs and the proportion of uninformed consumers were assumed to be determined by external factors. More recent papers[4] acknowledge that firms themselves can influence consumer search efforts, and may even engage in abuse of consumers' behavioural biases. To make higher profits, firms may seek to exploit certain groups of customers, who end up paying more than they otherwise would have done. These 'naive' consumers cross-subsidise 'sophisticated' consumers, who are much better at identifying the best deals and pay less. Such 'naivety discrimination'[5] relies on the naive consumers being 'boundedly rational'—in the sense that they make buying mistakes due to complex information, limited decision time or cognitive limitations.

For example, firms can affect consumer search by ranking search results in a particular order, or emphasising certain information through the use of features such as colour or font size, to direct consumers' attention to particular offers and information and away from other options. Another well-known example is mentioning limited product availability, to which consumers may respond by buying more than they would otherwise have done. Furthermore, online shops may deliberately create complexity, such as requiring many click-throughs or engaging in drip pricing, making it harder for consumers to compare offers and choose the best one. This increases the likelihood that they will buy from the most prominent shop, or from one of the first shops they visit.

The rationale for government intervention

Insights from marketing and psychology provide us with many other examples of the deception and manipulation of consumers.[6] Nobel Prize winners George Akerlof and Robert J. Shiller even suggest that, as long as there is a profit to be made, businesses will systematically exploit consumers' psychological weaknesses and their ignorance.[7] The economics literature shows that such deception and manipulation tactics tend to result in higher average prices and lower total consumer welfare,[8] even though in some markets sophisticated consumers may benefit at the expense of naive ones.[9] There is thus reason for governments to intervene: to improve information provision to consumers and to limit unfair business practices, in order to improve market efficiency and consumer welfare.

Fairness and vulnerability

Two additional concepts underlying the ACM's recent guidelines are fairness and vulnerability. There is an imbalance in power online between firms and (individual) consumers, and thus consumers need protection, potentially more so than offline. The potentially greater power of online firms, stemming from the possibilities for data collection and the ability to adapt choice environments to maximise sales, also brings with it a greater responsibility not to abuse that power—i.e. not to exploit consumers' weaknesses. This applies especially to consumers who find themselves in vulnerable circumstances, be it financially, mentally, or otherwise, and who may end up worse off than others for the very reason that they were more easy to mislead.

To ensure online firms take note of this greater responsibility, the ACM's guidelines hold them responsible for making sure that consumers understand the information that they, the firms, provide. As a result of fairer business-to-consumer trade, consumers will not just be treated more fairly, but they will also make fewer buyer 'mistakes' and grow more confident in online markets. This in turn will stimulate fairer competition, which will benefit not only consumers, but also firms that make genuinely better offers, as they will receive more sales.

Key principles in the ACM's guidelines

The ACM's guidelines are thus firmly rooted in considerations of efficiency as well as fairness. Let's zoom in on some of the key principles set out in the guidelines, and their economic and psychological rationales.

All prices must be clear prior to the purchase

Price is an important decision variable for consumers. If only part of the total price is advertised and the rest is not revealed until later in the buying process, or if the costs of possible add-ons or contract fees are hidden, consumers may be unable to correctly assess the total price and may end up buying more than they otherwise would have done.[10] To prevent this, the ACM's guidelines state that all prices should be clear a reasonable length of time before purchase, so that consumers can make an informed decision.

It needs to be clear to consumers when offers are personalised

Consumers may not mind if offers are personalised, and they may even appreciate receiving information and offers that are tailored to their personal preferences. However, what is often not clear to consumers is whether the advertised price is also personalised, dynamic (i.e. set in real time), or both. While this targeted pricing may potentially be efficient from a narrow economic point of view, it may actually be inefficient since it also enables firms to capitalise on consumers' biases and vulnerabilities, and to manipulate them into spending more than they would otherwise have been willing to pay.

Scarcity claims need to be truthful

Scarcity claims regarding product availability or time-limited offers can persuade consumers to purchase a particular product.[11] The ACM's guidelines stipulate that any such claims must be truthful and specific. For example, a claim on a hotel booking website saying that there are 'only 2 rooms left in the hotel you are looking at' should be accurate, given the total rooms available in that hotel (including on other platforms), and given the dates that the consumer is actually searching for.

Default settings should not be set to the consumer's disadvantage

People have a tendency to stick with the default. Online firms can use, or abuse, this fact by presenting pre-ticked choice boxes, thereby manipulating consumers into agreeing to purchase options they otherwise may not have agreed to. This includes essential terms and conditions that are hidden in a general terms and conditions document for which an 'I agree' box is pre-ticked. While default options are not forbidden per se, the guidelines state that if they are used, they need to be set in a way that is favourable to the consumer.

Search results must be based on the interests of the searching consumer

Consumers tend to compare only the first four or five ranked offers following an online search query.[12] All else being equal, platforms may be inclined to rank certain products higher if their sellers pay the platform for doing so. This alters the consumer's consideration set and may influence their purchase decision. The ACM's new guidelines require rankings to be based on organic search results and, if sponsored search results are included, these should be clearly labelled as being paid for by the seller.

Online reviews and social media 'likes' must be real and not manipulated

Research shows that consumers increasingly use online reviews as a source of information in comparing product offers.[13] Sales techniques that use the 'social proof' principle[14] by presenting reviews, testimonials, and social media likes may reduce consumers' propensity to compare offers, and accelerate their purchase decisions. Fake reviews and likes, which online firms can buy in bulk, are misleading. Sponsored recommendations by influencers should be clearly indicated as being exactly that.

Beyond the guidelines: other initiatives

The ACM's guidelines come at a time when there is increasing awareness among regulators of the influencing opportunities for online firms, and the need to set boundaries to the potential for misleading consumers. In the Netherlands, like the ACM, the financial regulator (the Autoriteit Financiële Markten) has recently consulted on its principles for online choice architecture.[15] Across Europe, Directive 2019/2161, as part of the EU's 'New Deal for Consumers', also strengthens consumers' rights online, by setting out transparency requirements for online market places and for ranking search results, among other things.

Beyond such initiatives, several authors have suggested the introduction of a code of conduct for digital platforms,[16] the use of consumer comprehension norms in 'performance-based consumer law',[17] or even a broader 'duty to trade fairly',[18] to improve competition, fairness, and market outcomes for consumers.

Going forward

Good information remains essential for well-functioning markets. Without it, consumers cannot properly compare offers, competition will not be stimulated, and consumers will end up paying more than necessary.

The ACM's guidelines give various examples of what constitutes 'good information'. At the very least, information should be complete. In addition, it should be correct, easy to understand and easy to find. But transparency alone is not enough, which is why the guidelines go further. They also prescribe that consumers should be able to assess relevant information before their purchase, and that the way in which information is presented should be logical and fair. Default settings should be used with caution and consumers' vulnerability should be taken into account. Finally, it is up to online firms to test how their business practices, including the use of algorithms, affect consumers, and to make sure that consumers see and understand the information that is provided.

In a similar fashion, it is up to the ACM to inform online firms of the guidelines and to make sure that the firms understand them, by engaging in dialogue with marketing executives, intermediaries and legal advisers, among others. The ACM has been doing just that, and will monitor compliance with the guidelines closely.

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