



Consumer Protection Models and Theories

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Consumer Protections Basics

According to the United Nations Conference on Trade and Development (UNCTAD):

“Consumer protection addresses disparities found in the consumer-supplier relationship, which include: Bargaining power; Knowledge; and Resources.” (p. 3)

Most economists studying consumer protection agree that some level of government intervention in markets is necessary to remedy market failures (Akerlof, p. 494; Issacharoff, p. 64; Llewellyn, pp. 43-44; Pasiouras pp. 904), while disagreeing about what form that protection should take and how far it should go. Beyond that, consumer protection takes different forms in different markets. Regulations applicable to food and drugs differ from those for children’s toys, and both vary greatly from the techniques used for consumer financial products.

Selling Lemons and Regulation Signaling

One of the primary issues academic literature on regulation attempts to address is information asymmetry. As Pasiouras puts it: “Information asymmetry is a well-known problem in the fields of economics, and it is frequently discussed in policy reports and academic studies on financial consumer protection” (p. 904). George Akerlof’s oft-cited paper “The Market for ‘Lemons’: Quality Uncertainty and the Market Mechanism” showed how quality uncertainty can lower the price buyers are willing to pay for a good. This in turn causes sellers of high-quality goods to exit the market, further lowering the price until even the sellers of low-quality goods may no longer find it worthwhile to sell their products (p. 490-491). This is further exacerbated by dishonest sellers who exploit the purchaser’s ignorance about the quality of the good being purchased which, as Akerlof notes, “is a serious problem in underdeveloped countries” (p. 495).

Due to the “lemon” problem along with other asymmetries between buyers and sellers, many economists note that the presence of regulation can actually contribute to more robust markets for particular goods. By regulating the good, a regulatory agency sends a quality signal by, in essence, disallowing low quality goods from the market. However, as David Lewellyn writes, “a moral hazard may emerge whereby consumers perceive there to be an ‘implicit contract’ between themselves and the regulatory agency” (p. 44). He further argues this belief of regulatory protection may cause some people to underestimate the risks around their consumption of particular goods, and services, especially financial products (p. 52).

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Information Disclosure and Paternalism

Because many of these market failures are related to information asymmetries, it is often argued that these failures are best addressed through providing more information to consumers (Issacharoff, p. 60; Pappalardo, p. 327). In theory, by giving consumers the information traditionally available to the producers the asymmetry will be alleviated. However, actual evidence on the effectiveness of information disclosure is mixed. Sometimes the information is written in a format which is difficult for consumers to understand or act on (Issacharoff, p. 167; Pappalardo, p. 327). One frequently cited example of unproductive information disclosure is the Terms of Service which accompany computer software. For the average consumer the information disclosure is too long and obtuse to be of any use.

Given the mixed results of information disclosure, economists have suggested different remedies. Pappalardo, for instance, has argued for uniform disclosure mechanisms which are thoroughly tested using the same methods of consumer research commonly used by marketing agencies (pp. 327-328). There is some evidence that this can be effective, one example being new labels for appliances which note the cost of running them for one year (Pappalardo, p. 328). Others argue that while this works in some instances, certain products (especially financial products) require too much expertise for most consumers to understand given limited time and the infrequency of their exposure to the market (Issacharoff, p. 167).

Others have argued for what is often termed “paternalism,” that is “the interference with a person’s liberty of action justified by reasons referring exclusively to the welfare, good, happiness, needs, interests or values of the person being coerced” (Dworkin as cited in Akinbami, p. 10). This is often justified through cognitive biases resulting in consumers unintentionally acting against their own best interest. The counterpoint is often that these regulations can stifle innovation, and unnecessarily limit consumer choice.

Still others attempt to split the difference using what is termed “soft-paternalism” or “libertarian paternalism” in which most people are directed towards what is likely in their best interest while still allowing them choice if their tastes differ from the norm (Issacharoff, p. 59). In essence, the goal is to use people’s bias towards defaults to protect them from their other biases. As Pappalardo notes, this requires those setting the default to actually know what is in the consumer’s best interest, which becomes difficult for some complex products (especially financial products) where the best choice is not known (pp. 325-326).

Common Approaches to Consumer Protection

Consumer protection can be accomplished through a variety of different means. Oftentimes how a country decides to provide consumer protection is dependent on its culture and norms. UNCTAD highlights six bodies which are often used to accomplish consumer protection goals: government agencies, statutory/non-statutory standards bodies, ombudsmen, professional and industrial associations¹, consumer associations, and self-regulation (pp. 7-8). Each of these bodies brings with it a unique set of advantages and disadvantages. Further details are provided below.

Government Agencies

Government agencies provide the most direct and traditional form of consumer protection. The restrictions put in place by government agencies range from simple disclosure requirements, as noted above, to product bans. They have the potential to create and maintain strong and efficient markets (Llewellyn, p. 44). Despite this

¹ In the time allotted for this report little information could be found on the role of professional and industrial associations in consumer protection. Further, the information found did little to differentiate them from self-regulation. For this reason, they are absent from the extended descriptions.

potential they come with their own risks, including regulatory capture - the regulator being overly or illegally influenced by a specific interest or interests, distortion of markets through improper regulation, and over-regulation (Llewellyn, p. 44). Further, with rapid pace of change and increasing internationalization of markets government agencies and laws are falling further behind the products they regulate (UNCTAD, pp. 25, 47).

Consumer Associations

In general consumer associations perform less direct protection, preferring instead to act as educators and advocates. However, how they enact those roles varies between developed and developing countries (UNCTAD, p. 34) In both cases consumer associations have attempted to represent consumers in national debates around consumer protection laws and regulations acting as a counterpoint to industry influence (UNCTAD, p. 33). Beyond this overarching goal consumer associations in developed countries tend to focus on providing unbiased reviews and product information (UNCTAD, p. 34). Meanwhile, consumer associations in developing countries work on consumer education, teaching people about their rights, responsible use of products, and/or how to protect themselves from scams and unscrupulous business practices (UNCTAD, p. 35). Developing economies present a unique challenge for consumer associations as limited resources often means they are funded either by governments or industry itself which can affect their mission and methods (UNCTAD p. 36).

Self-Regulation

Self-regulation takes on a variety of different forms and its effectiveness varies from place to place and industry to industry. Self-regulation can take on different forms from delegated governmental authority (the government mandates self-regulation but lets the industry create the rules) to entirely voluntary organizations (UNCTAD, pp. 45-46). The prime strength of self-regulation is the depth of knowledge and the speed with which self-regulatory bodies can respond to changes in the market (UNCTAD, p. 47). However, there is a great deal of skepticism around self-regulation, especially voluntary self-regulation. As UNCTAD notes: “[t]he further the code goes beyond the law, the less inclined a trader may be to join, unless all their rivals do so as well” (p. 45). The opposite can also be true, wherein “self-regulatory agencies may effectively impose barriers to entry” in order to decrease competition (Llewellyn, p. 44).

Statutory/Non-Statutory Standards Bodies

These are governmental or non-governmental bodies which create standards followed by a particular industry or product category. These standards can be enforced by law (statutory) or be entirely optional (non-statutory) (UNCTAD, pp. 7-8). The most well known of these standards bodies is the International Organization for Standardization (ISO) whose output is mostly non-statutory standards which organizations can choose to follow. UNCTAD makes special note of the role standards bodies play in setting rules around product safety (p. 68) where these agencies often play a prominent role. The standards set by these bodies are not limited to direct consumer protection. A common example would be interoperability standards such as those in the Institute of Electrical and Electronics Engineers (IEEE) 802.11 standard which pertains to all devices using the Wi-Fi protocol.

Ombudsman

The primary role of the Consumer Ombudsman is to provide dispute resolution between consumers and firms. According to UNCTAD: “[t]he Consumer Ombudsman is a... supervisory body with the task of ensuring that marketing methods used by a business when selling goods or providing services conform to the law” (p. 94). The Ombudsman investigates complaints and has wide latitude to rule beyond the legal requirements if they judge the specifics of the transaction to go beyond “good industry practice” (UNCTAD, p. 94). In Denmark the

Ombudsman is the sole entity capable of bringing opt-out² class action lawsuits on behalf of consumers (UNCTAD, p. 93) While public sector Ombudsmen have spread to Latin America, the consumer variant was largely a European institution as of 2016 (UNCTAD, p. 95).

Digital Consumer Protection

The move to a digital economy creates new issues for consumer protection. The Consumers International report *Connection and Protection in the Digital Age* highlighted four problems which are likely to get worse as more products and services are connected to the internet: security, complex liability and responsibility chains, data collection and use, lack of transparency and clarity (pp. 28-32). Each of these requires different protection responses due to the nature of the problem. In addition, lack of transparency and clarity acts as an amplifier for the other issues as many people are unaware of exactly how the digital devices and services work (pp. 28-29).

Security

Security provides a unique challenge. Many of the devices and services which connect to the internet are increasingly being made by non-specialist companies with little security experience (Coll & Simpson, p. 32). Further, without advanced technical knowledge consumers are unable to determine if the devices they use are secure. Increased ease-of-use leads to a decrease in understanding of how the user may be exposed to security threats. Due to the ever-evolving nature of security, legislation is often outdated before it is passed making this a prime area for co-regulation, a scheme where the government delegates responsibility for setting standards to industry bodies which all firms are required to follow (UNCTAD, p. 45).

Data Collection and Use

Increasingly technology companies most important asset is the data they have collected on their users. As noted by Coll and Simpson: “With applications made with privative [*sic*] software operating in the background, it will become more difficult for individuals to see if, when and how processing takes place...” (p. 31). As more digital services and connected devices penetrate into people’s lives their ability to control their data decreases. Again, this is exacerbated by people often being unaware of exactly how the services work or what is being collected (p. 31). As is further noted in the report: “[w]hile providers have ample opportunity to stipulate terms of use, maximise their demands and minimise responsibility... consumers are only able to accept or decline the services” (p. 31).³ That is the companies are able to use their increased bargaining power to force terms on consumers who are increasingly dependent on these services for work, banking, and many other essential activities.

So far self-regulation has proven inadequate on this front. The European Union has recently enacted the General Data Protection Regulation (GDPR) with the goal of decreasing the collection and use of private

² An opt-out class action lawsuit is the form standard in the United States. In this method a suit given class-action status will see all consumers affected by the decision as party to the suit. In Europe class-action lawsuits are considered “opt-in” meaning consumers have to actively choose to be party to the suit. This, and other regulations, have stopped class action lawsuits from being widely adopted as a method of consumer redress in Europe (UNCTAD pp. 92-93)

³ The End User License Agreement/Terms of Service has caused consternation beyond privacy concerns. The UNCTAD report cites the United States President’s Council of Scientific Advisors as having a similar concern about consumers’ inability to negotiate (or even understand) terms with service providers and the weakening of consumer bargaining power (p. 3). Later the Consumers International report (p. 43) cites UK Consumer Advocacy, which termed this practice “tick, click and hope for the best” which was also quoted by the UNCTAD report (p. 3).

data. It is too early to tell how effective this legislation will be (UNCTAD, p. 112) It is also worth noting this law only protects citizens of European Union countries.

Complex Liability and Responsibility Chains

With an increased amount of data sharing between various firms, it can become increasingly unclear which companies have access to the user data or who is responsible in the case of a data breach. As the United Kingdom's Information Commissioner's Office writes this "can lead to complex scenarios where the individual will not have a clear understanding of all the parties involved, how their information is being shared or for what purpose." (as quoted in Coll & Simpson, p. 29). It can also lead to difficult situations when assessing fault for a security breach; "[it] could be the fault of an ISP, payment facilitator or intermediary or the product itself" (Coll & Simpson, p. 29) Creating any sort of regulatory solution for this seems difficult. Self-regulation is unlikely as these practices are often required to make complex services work as well as integral to industry business models. Outside regulation, meanwhile, could significantly limit potential benefits of responsible data sharing or be largely ineffective as regulators stumble in relative darkness.

Conclusion

Which types of consumer protection are most effective and who offers protection varies from industry to industry and country to country, and debates among academics continue on issues as seemingly trivial as the correct number of consumer financial protection agencies to fundamental questions about whether solely regulating market failures goes far enough. Still, it is widely agreed that consumer protection is a necessary part of a functioning market and the government has some responsibility to act when markets fail.

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