Economic regulation

Nudge nudge, think think

Behavioural economics is changing regulation. Payday lending is a target

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IN 2010 the Conservative-led government established a team—known affectionately as the "nudge unit"—to investigate how behavioural economics could be used to improve policy. Behavioural economists argue that consumers are not hyper-rational but have predictable biases, and they use insights from experiments to make models imitate reality more closely. The nudge unit was so successful at finding clever policy insights that it was part-privatised and has been advising other governments. Now, behavioural economics is changing the way Britain's regulators think about the markets they regulate.

The keenest wonks are found at the Financial Conduct Authority (FCA), which has been scrutinising the controversial payday lending market. Payday lenders offer short-term loans at astronomical interest rates. One problem with this market, says the FCA, is that borrowers may suffer from "present bias". It is not just that people prefer jam today to jam tomorrow; they also fail to foresee that when tomorrow comes, they will have the same skewed preference. This leads to optimism about future behaviour. Consumers take out expensive loans expecting to repay them quickly. Instead, they spend more than planned and end up in financial trouble. The FCA has found that some borrowers are worse off six months to a year after taking out a loan; they have lower credit scores, for instance, and are more likely to default on other debts.

The FCA has made multiple interventions in the market. In April, it introduced tough new affordability checks and limited lenders' access to borrowers' bank accounts. In July, it proposed a cap on interest rates. On October 2nd, Wonga, a payday lender, announced that it would write off £220m ($350m) which the FCA says it lent without adequate affordability checks. The Competition and Markets Authority is also intervening to establish a price comparison website. But soon there might not be many offers to compare; the FCA predicts that when its price cap is implemented in January, all but four of Britain's 400 payday lenders will exit the market.

Canny firms in many markets appear to understand behavioural economics. In March, the Office of Fair Trading (OFT) intervened to prevent six furniture and carpet retailers from claiming shoppers were benefiting from big discounts when hardly any sales had been made at the undiscounted price. As it is easy for companies to claim they are offering discounts, traditional economics suggests the consumer will anticipate their trickery and ignore the "reference price". But, in an experiment, the OFT found that reference prices lead to less shopping around, benefiting traders who deploy them. A race-to-the-bottom can result. Competition is normally a good thing but, with behavioural economics in hand, British trustbusters argue that rivalry can sometimes be harmful, as scrupulous firms will fall behind their crafty rivals.

In many markets consumers fail to switch supplier to take advantage of better deals. This can be partly explained by present bias; consumers endlessly postpone the paperwork. Another contributing phenomenon is "loss aversion"; people dislike losses more than they like equivalent gains. This makes them assign disproportionate value to services they already have. Such inertia on the part of consumers gives firms more leeway to raise prices. That worries Ofgem, Britain's energy regulator. The average British consumer on a single fuel energy tariff would save nearly £100 a year by switching supplier, yet in the second quarter of 2014 only 2% did so. Ofgem wants firms to simplify their tariffs, making them easier to compare, hoping that will nudge consumers toward action.

As a result of all this, an OECD report in January declared Britain a world leader in applying behavioural economics to regulation. But not everyone is celebrating. Professor Stephen Littlechild of Cambridge University, a former regulator himself, says that even if consumers make mistakes, regulators—who are human too—should not always assume they know better. Behavioural economics is controversial because it can suggest interfering with personal choices. Some might prefer to learn from their own mistakes. Yet, so far, most regulatory interventions have focused on improving consumers' access to clear information. That must be good.

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