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Efficient Penalty Clauses With Debiasing: Lessons from Behavioral Law and Economics

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INEFFICIENT CLAUSES OR CONSUMER CHOICES?
LESSONS FROM BEHAVIORAL LAW AND ECONOMICS

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ABSTRACT
This paper is an attempt to highlight how the clauses that are traditionally considered to be inefficient may actually be desired by consumers. This anomaly has its origin in the fact that each individual builds a mental budget by dividing up the money he has among the needs he intends to satisfy. According to consumers’ reasoning, money is not fungible, in the sense that amounts cannot be transferred from one expenditure item to another. Consumers that behave in this way may sometimes find that they have finished the amount they budgeted for an item while wanting to buy some more of it. Since additional time, efforts and risks are not in the budget, consumers accept clauses that are traditionally considered to be inefficient so as to stay within their budgets while increasing the amount they can spend for a given good. Thus, for example, since additional time and efforts are not counted in the budget, a consumer will be willing to make a sacrifice with a value of 6 for a service that would cost the producer 3. This is apparently an inefficient solution but it allows the consumer to stay within his budget.

INTRODUCTION
In the last thirty years cognitive psychology has raised serious doubts about the model of homo oeconomicus. The aim of this science, which, in all truth, was not born for this purpose, is to show how individuals really behave and not how they should behave according to instrumental rationality. The results of cognitive psychology have duly taken their place in the mainstream of economics and the Israeli psychologist Daniel Kahneman, a pioneer in the field, was awarded the Nobel prize in economics in 2002.

The model of homo oeconomicus, i.e. of individuals who are selfish and rational and therefore able to maximize their utility, has been contested, on the basis of theoretical observations and empirical data, by behavioral economics or, more simply, by cognitive psychology. For some decades now, this branch of science has subjected individuals to experiments and theoretical studies and has identified systematic behavior that differs from traditional economists’ model of rational man (so-called biases) or simply
simplify the model of deciding (heuristics). Initially cognitive psychology did not actually set out to question economics (for example, some studies sought to understand why the German masses had passively obeyed
Hitler’s orders but with the Israeli psychologists Kahneman and Tversky attention came to be focused on the comparison between the man in microeconomic manuals and real man. These psychologists identified two types of behavior that, as already mentioned, differ, at least in part, from microeconomic models: heuristics and biases. Heuristics are mechanisms by means of which individuals choose on the basis of a serious lack of information. It is as if decisions were taken by flipping a coin. It is not that such behavior differs from that of homo oeconomicus, who also has to make highly imprecise choices in the absence of information. For this reason heuristics are not considered as true systematic deviations from rationality. The situation for biases is very different: these are behaviors that appear to be a constant, systematic and non-random deviation from the principles of instrumental rationality. By examining biases, cognitive psychologists have cast serious doubt on the main parameters of traditional economics and, more generally, on the theory of expected utility.

A good example of bias is “status quo bias”. As a consequence of this systematic deviation from rationality, individuals prefer not to take decisions or, better, to remain in the position they have come to occupy, either by chance or as a result of the work of a social architect. Thus, if a form is prepared for workers and they are asked to put a cross in a box if they intend to sign up for a supplementary pension, a very low percentage will put a cross (the so called opting-in). If instead the question is posed in the form of a possibility to opt out, i.e. workers are asked to put a cross in the box in order to be excluded from having a supplementary pension, the percentage of workers who accept a pension is very high. It all depends on how the question is framed and by the request for the worker to make a commitment. The way in which the question is drafted is also known as “framing”. For rational persons the questions referred to above should be identical since the cost of putting or not putting a cross in a box is negligible and he should therefore decide so as to maximize his preferences. Instead real people allow themselves to be influenced and do not make a careful assessment of what is best for them in light of their preferences. It is as if they were guided by a force of inertia. They prefer what they are offered and do not take the trouble to opt out when that would be optimal in light of their preferences. This preference for the status quo has given rise to a doctrine known as libertarian paternalism. This doctrine does not set out to impose a choice on anybody, as will be shown below, but seeks to have the default choices best suited to each individual accepted by exploiting inertia. The individuals who must make the choice can also invoke a waiver clause and it is for this reason that the adjective “libertarian” is used. The paternalism lies instead in the fact that, by passively accepting the default choices, individuals effectively allow themselves to be guided by the state or a social architect. Libertarian paternalism can have a great many applications, from the field of social security to that of health care.

An example of a heuristic is the so-called “availability heuristic”. The question one can ask is: should we really worry about hurricanes, earthquakes and power plant explosions? What is found with experiments carried out with humans is that individuals consider an event to be very likely if it is in the front of their minds because it has just happened or because they have just heard about it. Thus, if there is an earthquake, each individual will consider there is a high probability of an equal one occurring in their area. The more easily individuals can imagine important events, the more worried they are that these are very likely to occur, even if the statistics and geological research indicate that the probability is very low and that nothing has changed. For example, a familiar risk, such as that associated with the attack on the Twin

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Towers in New York on 11 September 2001, is considered more serious than a non-familiar risk, such as that associated with excessive exposure to the sun or a very hot summer.²

THE MENTAL BUDGET

Among the various discoveries that psychologists have made there is that consisting in the behavior of individuals in mentally dividing the amounts to be spent on the various goods that they wish to buy. This is known as mental accounting or mental budgeting.³ Thus, if A has mentally decided to spend twenty dollars on apples, he will not spend more than that even if an additional apple would increase his utility. It is as if there were so many jars⁴ in which to put the money for each good and once the jar has been emptied the spending on that good is over. The mental division of the budget into the amounts for the various items that individuals must buy has been confirmed by much empirical research and can be considered a deviation from standard rationality because individuals should choose the goods that give the greatest utility without considering the limits set for the spending on each item.⁵

It is possible that a man will have used all the money he had allotted to buy a given good. What can he do to increase his purchases?

Here we can say that we believe real men have a sort of reserve available to them, consisting in the acceptance of clauses that permit a lower price but which are to their disadvantage and inefficient. More precisely, the reserve consists in willingness to make additional efforts, devote more time and run risks. Imagine that A has spent all his budgeted amount for buying apples. Home delivery by the seller costs 3 while for A to go and get them entails a sacrifice, in terms of effort and time spent or risks run, amounting to 6. At this point the efficient rule would be for the seller to deliver the apples to A, but A has 3 still available with which to buy another apple and having spent the whole of his budget for the purchase of apple se may accept the sacrifice of going to get the goods. In order to increase his purchases with the share of the spending he has foreseen in his mental budget, A accepts an inefficient clause. As a consequence of his mental accounting, ha cannot transfer 3 from one category of spending to another⁶.

According to traditional economic theory, which considers money to be fungible, a rational individual would have taken 3 from one of his mental jars and paid for the delivery of the apples, thereby obtaining a gain of 3. The real man, who does not want to violate the rules of his mental budget, of his allocation of the

⁴ The jar image is taken from R. Thaler and C. Sunstein, Nudge. Improving Decisions about Health, Wealth and Happiness,
⁵ Again with regard to mental budgeting , reference can be made to M. Motterlini, Economia Emotiva, Milan, 2006, p. 19 ff.
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amount available among the various goods, prefers to incur the cost of 6, in terms of time, sacrifice and risks, rather than alter the distribution of his spendable amount.

This interpretation is a possible new explanation of the inefficient clauses that are found in contracts. Firms, once they have fixed a price and consumers have spent the entire amount they budgeted for the purchase of the good in question, introduce inefficient clauses that give consumers a new possibility to make purchases and thus to spend additional amounts on the good. However, they will have to accept an increase in the time they spend or the risks they incur or, more generally, accept a sacrifice that entails a saving of money. In short, firms can be said to insert unfair terms to their advantage and at the same time to reduce the price of the good, so as to maximize their sales.

The phenomenon is even more pronounced in the case of a monopoly. Consumers perceive that the price they are paying is too high and have no intention of paying any additional amounts to the monopolist. The price that real consumers deem to be fair is defined by cognitive psychologists as the “reference price” and tends to coincide with the “average cost of production”. In order to increase their purchases, however, these consumers will be willing to accept inefficient clauses that are entirely to the advantage of the monopolist, so as to have more money available for the purchase of the good in question.

But the most important application of this theory is in the case in which market becomes monopolized. In this situation, consumers don’t want to increase the amount of money to spend for the good whose market has been monopolized and accept that clauses. So mental budgeting can be a plausible explanation of inefficient clauses that we find in standard form contracts of monopolist. Since the article written by Alan Schwartz about monopoly, law and economics scholars have considered a dilemma the fact that monopolist clauses are very harsh. Monopolist should offer the same clauses that are offered in a perfectly competitive market. Economist as coined the sentence “X inefficiency” to indicate the inefficiency of monopolist.

The theory of mental budgeting can give a convinced explanation to this phenomenon.

When heterogeneous consumers converge on a market, firms are faced with the following dilemma: whether to insert efficient clauses to meet the requirements of wealthy customers with a high mental budget or to insert inefficient clauses to allow less well-off customers to buy larger quantities of the goods they produce. In theory the market should be fragmented: some firms will aim at the rich customers and others at the poor ones. This appears to be what basically happens in practice, but a problem arises if there is a monopoly market. In this case the monopolist can be expected to try and win over marginal customers, i.e. those that have already spent the whole amount they budgeted for the purchase of the good in question, and it will do so by inserting clauses that are to its advantage and free a part of the money that can still be spent on purchases of that good by increasing consumers’ mental budgets through the inclusion of sacrifices of various kinds that are not counted, instead, in the budget. From this standpoint it is not to be expected that the terms included by the monopolist to win over marginal customers will be efficient ones with regard to the latter’s preferences but rather inefficient ones allowing them to make a saving that they can use. So from different point of view it’s possible to say the theory of mental budgeting gives an explanation to the inefficiency of monopolist clauses.

1 Schwartz A.A Reexamination of Nonsubstantive Unconscionability," 63 Virginia Law Review 1053 (1977)

Thus, a clause introduced by the monopolist waiving liability for harm caused by the good sold to customers can be seen as an efficient clause because marginal consumers have a low risk of suffering harm, but it can also be seen as an inefficient clause that serves to free resources to be spent on additional purchases of the good in question. It is as if individuals have a reserve of energy, time, resilience and acceptance of risk that they use to increase their purchases of the good, even if that energy, time, resilience and risk have a greater cost in money terms than what the counterparty would have to spend to take the same action in the customers’ interest (so that it would be optimal to include a clause that would require the firm drawing up the contract to bear the burden of the service).

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According to R. Thaler, “Mental Accounting and Consumer Choice”, 4 Marketing Science 199 (1985), a monopolist could decide not to establish a monopoly price so as not to create what is known as transaction disutility, i.e. the disutility for consumers because they are faced with a price different from the reference price. Such behavior would be justified both to maintain relations with habitual customers and to attract new customers who could become habitual customers in the future. The example the author gives concerns important sporting events. The companies involved know that they are selling the tickets at a price that is too low, but in this way they satisfy their customers’ expectations and if scalpers subsequently sell tickets at high prices, they and not the companies organizing the events are blamed for the price not being fair. The key concept is therefore that of the utility (or disutility) for customers generated by their paying a fair price or not.
THE TRADITIONAL INTERPRETATION

If that is how things stand, one should not accept the interpretation according to which firms exploit information asymmetry to include inefficient clauses that consumers do not notice. Consumers prefer clauses of this kind. It follows from the traditional interpretation that a mandatory change to such clauses in order to make them efficient, even if it causes an increase in the overall price of the good, would put consumers in a better position because, for example, they would pay an increase of 2 for a clause that is worth 5 to them. They would therefore stand to gain 3. The interpretation put forward here, instead, stresses the fact that consumers, once they have used the amount they have allocated in their mental budgets for the purchase of a given good, do not want to spend any more on that good but are willing to make efforts, devote time or run risks to save on what they would spend and use this saving to buy other goods of the same type (since it is reasonable to imagine that when the producer changes the terms in his favor he will also lower the price in response to competition). It can therefore be said that we are faced with an example of irrational behavior, of a bias, but empirical experiments may justify such behavior.

The law on abusive clauses contained in the Italian Consumer Code, which is a direct consequence of a series of European directives, could thus have a double interpretation: on the one hand it could appear to provide an efficient legal framework because it eliminates the clauses that consumers do not want and for whose removal they would be willing to pay an amount greater than the production cost; on the other hand it could upset mental calculations, the mental accounting of real men, who would find themselves unable to save by accepting sacrifices and costs and devoting time so as to be able to buy additional quantities of the good in question, even when the sacrifices accepted by the consumer have a negative economic value greater than the cost of amending the clause.

A traditional economist’s assessment of such behavior would be in terms of inefficiency, because consumers are going to accept a sacrifice that is greater than what they would be willing to pay to avoid it. However, the allocation of their total spending among different jars, i.e. mental budgeting, does not allow money to be transferred from one jar to another. Bias would cause the irrational behavior.

It is thus a question of understanding the role that the legislator could play in a situation of this type. A first answer comes from the school of thought that, as mentioned earlier, is known as libertarian paternalism. According to this doctrine, the legislator should direct individuals towards a choice, while always leaving them the possibility of opting out. The term “paternalism” is used because, owing to the status quo bias, the legislator’s default choice is often the same as that of individuals. An economic man would have no problem in opting out if this were his best choice and the costs of dropping out were low. Real men tend to stick by the default rules, even when the cost of opting out are minimal, truly negligible. They are guided by a force of inertia.

At this point the legislator, following the route of libertarian paternalism, could insert efficient default
clauses, with the aim of encouraging real men to make the choices that would maximize their welfare. The problem is that if libertarian paternalism is to remain true to itself, it would need to adopt provisions that are variable by agreement, and this would raise the question of the derogations from these provisions that the drafting firm can introduce. In other words, even if the legislator were to choose efficient clauses relying on consumers not asking to opt out, the drafting firm will insert inefficient clauses that are to his advantage and allow consumers to save on what they would spend and use this saving to buy more of the good produced.

The UE legislator has taken more effective action in its transposition of enabling a Community Directive\(^3\); it has provided for clauses that cause a significant imbalance between rights and obligations to be null and void; such clauses can be considered, with a fair degree of approximation, to be inefficient clauses and in this way consumers are no longer free to choose an inefficient clause entailing a sacrifice in terms of energy and time, so as to have more money available\(^4\).

Starting from the model of the micro-economy, the market in which the standard forms for governing relations are present tends to fail owing to adverse selection (the market for lemons). Starting instead from cognitive psychology research, one could arrive at the conclusion that the market supplies what real men want, even if on the basis of homo oeconomicus models that is irrational.

**THE POSSIBLE SOLUTIONS**

At this point the problem becomes of a philosophical nature: should individuals be left free to choose even when they appear to make mistakes, because the preferences they reveal are those that they feel as their own, or should they be guided towards the options that according to criteria of instrumental rationality appear to be optimal?

Finding a solution that does not violate the liberal principle and that meets the needs of regulations that can be applied turns out to be very difficult. The fact that the Italian Consumer Code (and the legislation of many other European countries) has declared abusive clauses to be null and void without providing for an increase in the consideration for the drafter under the clause more favorable to consumers that becomes part of the contract, leads consumers to opt to apply for clauses to be declared null.

If the legislator had foreseen that it would have been necessary to revise the consideration to recompense the drafter for the greater expense incurred, we would have had a solution similar to what was being sought: consumers wishing to maintain the abusive clauses so as to have a saving of money would not have taken any action; by contrast, consumers preferring the efficient clauses would apply for clauses to be declared null, taking account, while recognizing that the consideration would have been revised to consider the greater expense incurred by the drafter. But what has been described above may appear to be an excessively difficult legal system to apply, one that more than anything else would generate iniquitous results. In fact, knowing that the consideration will be revised upwards if a clause is declared to be null, the drafter will have every possible incentive to insert inefficient clauses, since, in the worst case, together with

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\(^4\) For the situation in Canada it’s interesting the report “Ending abusive clauses in consumer contracts”, available at the internet address: http://uniondesconsommateurs.ca/docu/protect_conso/EndAbusiveClauses.pdf
the declaration of nullity, it will receive an increase in the consideration that will make good its losses. Its dominant strategy will therefore be to insert inefficient clauses.

CONCLUSIONS

In this paper an attempt has been made to highlight how the clauses that are traditionally considered to be inefficient may actually be wanted by consumers. This anomaly has its origin in the fact that each individual builds a mental budget by dividing up the money he has available among the needs he intends to satisfy. According to consumers’ reasoning, money is not fungible, in the sense that amounts cannot be transferred from one expenditure item to another. Consumers that behave in this way may sometimes find that they have finished the amount they budgeted for an item while wanting to buy some more of it. Since additional time, efforts and risks are not in the budget, consumers accept clauses that are traditionally considered to be inefficient so as to stay within their budgets while increasing the amount they can spend for a given good. Thus, for example, since additional time and efforts are not counted in the budget, a consumer will be willing to make a sacrifice with a value of 6 for a service that would cost the producer 3. This is an inefficient solution but it allows the consumer to stay within his budget.

If this is how things stand, inefficient clauses that are deemed to enter into contracts as a consequence of information asymmetry could instead be clauses that consumers actually want, even if on grounds that would traditionally be considered irrational.

From this it should follow that there is a need for caution in mandatorily replacing inefficient clauses in contracts because that entails an increase in the consideration and puts consumers in an uncomfortable situation.

This does not mean that the theory of budgeting is the correct one; the aim is only to encourage judges to decrease the tendency to nullify all clauses that create a significant imbalance between rights and obligations to the disadvantage of consumers. (and this reasoning regards all European jurisdiction) Mental budgeting theory is supported by an extensive empirical literature and it would therefore be a serious error not to take it into account.