Regulatory Techniques in Consumer Protection
Lecture 3:
Mandated Protection and Access

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Mandated Consumer Protections

Pro-consumer arrangements that cannot be contracted away

- Minimum quality of rental housing
- Mandatory warranties
  - Lemon laws
  - Products liability (personal injury)
- Mandatory right to withdraw from transaction
- Maximum rates in consumer credit transactions
- Non-recourse debt contracts
- Non-contestable insurance contracts

Mandated Open Access

Social policies to promote (and fund) universal access to:

- primary and secondary education, public parks, roads, libraries, museums, emergency services
- information (mandated disclosure)
- courts of law
- markets

Justified by progressive redistributive goals

A cross-subsidy of the beneficiaries of open access, who otherwise could not afford to purchase the access

Mandatory Protection: The Price Effect

The standard perspective: "Ex-Post" fairness: Improve the outcome for weaker consumers

– The mandated protection guarantees a better deal

The economic perspective: "Ex-Ante" effects: The protection affect other parts of the contract

– Mandated protections increase prices
– Shrink the market, forcing some consumers to exit

The Price Effect

Case I: Inefficient mandate

Cost to sellers > value to buyers

Example: mandated anti-theft alarm system

	Without alarm	**With Alarm**
Cost to landlords	100	120 (+20)
Value to tenants	100 – 150	110-160 (+10)

Assume: Price = cost

➔Price increase from \$100 to \$120

All tenants are WORSE OFF:

- Some tenants (Value > 120) continue to purchase, but pay \$20 more for a product worth only \$10 more
- Some tenants (Value < 120) drop out of the market

The Price Effect

An Inefficient mandate <u>hurts</u> consumers if the cost of the mandated protection is fully rolled into the new price

Craswell: Inefficient mandates hurt consumers even if sellers absorb some of the cost!

- This is less obvious
- The reason: the decline in QUANTITY produced

The Price Effect

Case II: efficient mandate

Cost to sellers < value to buyers

Cost = \$20; Value = \$30

	Without alarm	With Alarm
Cost to landlords	100	120
Value to tenants	100 – 150	130-180

➔ Price increase to \$120, but **All tenants are BETTER OFF**:

- tenants that were served before the mandate continue to be served, but are better off by (net) \$10
- Some tenants that were NOT served before are now being served
  - E.g., original value =\$95; new value = \$125

The Price Effect

Conclusions:

- When the mandate is inefficient, it harms all consumers
- when the mandate is efficient, it benefits all consumers

➔Only efficient mandates are justified

But if everyone benefits, why do they have to be mandated?

The harder question: What happens if consumers are heterogeneous? If some value the mandate more than others?

The Cross-Subsidy Effect

Assume:

- Consumers value the mandate differently
  - Some have HIGH value
  - Some have LOW value
- Firms <u>cannot</u> distinguish types of consumers
  - Firms have to charge uniform prices to all consumers

The Cross-subsidy effect:

- Consumers with LOW value cross-subsidize the ones with HIGH value
- The net transfer is from one group of consumers to another
  - It is NOT a transfer from the firm to consumers

The Cross-Subsidy Effect: Illustration

Mandatory full compensation for undelivered mail

Example: 100 consumers; loss/compensation is either \$10 or \$500

Consumer type	Frequency	Loss
High Loss	10	\$500
Low loss	90	\$10

Total cost of liability for mail carrier:

$$10 \times \$500 + 90 \times \$10 = \$5900$$

Cost of liability per transaction:

$$\$5900 \div 100 = \$59$$

➔ All consumers pay \$59 <u>more</u> in the price of postage.

The Fairness of Cross-Subsidy Effects

The Cross-Subsidy can be PROGRESSIVE, favoring low-income consumers:

- Building access for people with disabilities
- Mandatory health insurance (flat prices)
- Universal mail service (flat prices)

The Fairness of Cross-Subsidy Effects

The Cross-Subsidy can be REGRESSIVE, favoring the elite:

-All consumers pay the same prices or fees

-Some consumers derive greater benefits from the feature (“HIGH USERS”)

-These HIGH USERS are disproportionately

- High income
- High education
- High sophistication

Regressive Cross-Subsidy: Examples

1) Mandated compensation
   - Consequential Damages for breach of contract (mail example)
     - Value of package correlated with wealth
   - Mandatory warranties
   - Products Liability: compensation for harm from products
     - Harm is measured by lost income
   - Punitive damages

high income consumers have

- Higher losses
- Better knowledge of the warranty terms
- Higher propensity to seek redress

Regressive Cross-Subsidy: Examples

2) Mandated exit rights

- Right to withdraw from contracts:
  - European Legislation: 14 days
- Regulation of termination fees

Poor consumers cannot afford the extra price for these rights

3) Mandated benefits

- Mental health benefits (health insurance)
  - Study: Whites take advantage 4x more than Blacks
- Exam accommodations
  - Data: Wealthy town have 5x higher incidence
- Higher Education subsidies?

Regressive Cross-Subsidy: Examples

4) Mandated access to court

The debate over pre-dispute arbitration clauses

- Standard complaint: firms insist on arbitration in order to limit their liability
  - A Transfer from consumers to firms!
  - To protect consumers, the law should prohibit these arrangements
- The cross-subsidy perspective: firms insist on arbitration in order to reduce their costs and pass these savings to consumers
  - Eliminate a cross subsidy among consumers
  - Some consumers benefit, others lose
  - Who?

Sophisticated consumers benefit from access to litigation

- Recognize that their rights were violated
- Manage to hire a lawyer
- Have the patience to await judgment

➔ The propensity to sue is higher among sophisticated, high-income, elite consumers

Interim Conclusion:

pre-dispute arbitration clauses in consumer contracts eliminate a regressive cross-subsidy

Class Actions

Arbitration clauses have the additional effect of barring class actions

Do class actions serve the interest of the less-sophisticated consumers?

- Compensation without having to file suits
  - But, redemption rates are very low
- Deterrence
  - Enjoyed by all consumers
  - But the deterrent effect has differential impact
    - Higher prices
    - More warnings

Conclusions

- When consumers are heterogeneous, mandated protections and mandated access has <u>differential</u> impact
- In important areas, the impact can be regressive, helping less those who need protection the most
- Through the price mechanism, this differential impact can make the weakest consumers overall worse off
- “Universal” protections are particularly susceptible to this problem
- Many protection may still be desirable, but lawmakers should pay attention to the unintended effects

The End