1. INTRODUCTION

Consumer protection has generally been understood as a wide range of different regulatory tools to protect weaker market parties. Consumers have been generally defined as natural persons acting for purposes outside their trade, business or professions who should be protected when they are unable to discipline firm behaviour in the market by simple mechanisms of reputation and repeat sales and who cannot effectively enforce their rights. When social norms do not work, governments may intervene in order to adjust the environment where consumers bargain and conclude transactions. The economic justification for intervening in consumer contracts is based on the idea that regulatory tools can remedy the main sources of inefficient consumer contracts such as high transaction costs and information asymmetries.

The law of consumer protection is of relatively recent origin and it can be argued that the economics of consumer law has only recently been extended and enriched into a widely discussed scientific area of law and economics. The reason for that is to be found in the fact that neoclassical economics traditionally rested upon the rational choice theory, assuming that consumers are rational market players and know best how to increase their welfare in the market. This theory has been now challenged by empirical research from behavioural economics, which has questioned both rational choice theory as a behavioural model as well as the legal regulatory framework of consumer protection.

Accordingly, this chapter will summarize the mainstream economics that have been applied to legal rules of consumer protection. It focuses on insights from neoclassical and behavioural economics. Moreover, it discusses the most prominent law and economics issues of EU consumer law. While it could be argued that the economics of consumer protection is in fact the economics of information (Shapiro, 1983), the economics of European consumer protection is concentrated in the economics of harmonization. The economic function of EU consumer rules is to intervene with national law by imposing restrictions on the freedom of contract of local economic actors. The exact form and content of these mandatory rules, however, is subject to debate. Fundamental questions are located at the intersection of supranational EU mandatory rules and national contract rules safeguarding the freedom of contract.
This chapter is organized as follows. Section 2 sets out, on the one hand, the economic analysis of consumer protection law and, on the other, the two main economic theories of consumer protection: neoclassical economics and behavioural economics. Section 3 discusses the different behavioural models of the consumer in the rational choice theory and behavioural economics. Section 3, furthermore, provides an illustration of the application of economics to the legal definition of the consumer and the discussion on how to design legal rules for the protection of vulnerable and average consumers. Section 4 gives a short overview of the main regulatory tools of consumer protection and illustrates how economics demonstrates the effects of these legal instruments. Section 5 deals specifically with the main message of economics for consumer law: consumer protection comes at a cost and it generates distributional effects. Section 6 is about the enforcement of consumer rules and discusses private and public enforcement, alternative dispute resolution, collective actions and finally remedies and sanctions. Finally section 7 closes with the EU’s regulatory model of consumer protection by focusing on the economics of harmonizing consumer rules. A summary rounds up this chapter.

2. THE ECONOMICS OF CONSUMER PROTECTION

Markets represent a complex contracting environment where incomplete consumer contracts can arise due to various market failures. Potential market failures such as market power and entry barriers are issues that competition law deals with. Transaction costs, externalities, information deficits and cognitive dissonances are accepted arguments that justify state intervention through mandatory rules. The most valid economic reasons for intervening in market processes and altering contractual conditions in order to protect consumers are transaction costs and information asymmetries. Transaction costs can be reduced by setting default rules in contract law or by simple market mechanisms such as reputation, brands or warranties that signal relevant information to consumers (Luth, 2010). Government intervention through mandatory rules depends on how the costs of such intervention in terms of drafting and implementing rules, consumer moral hazard, decreased consumer choice, government failure can be balanced with benefits, such as more efficient and complete consumer contracts.

This is relevant because mandatory rules alter contractual terms and impose a restriction on freedom of contract. They exclude particular deals and overrule individual preferences. Mandatory rules are often subject to criticism on three points. They act as a compulsory insurance policy and they raise the prices of goods and thus create costs for both business and consumers. Mandatory rules decrease competition by excluding low-quality, cheap prod-
ucts from the market that could be of benefit to less affluent consumers. They also reduce individual incentives to take care in choosing products or services (Cartwright, 2006).

Accordingly, the regulatory question is often which market failures warrant intervention and the enactment of mandatory rules and which can be cured by the market or by relying on default rules (Ayres, 2003). While lawyers assign rights to consumers on the basis of justice and fairness, economics uses a cost-benefit analysis and takes welfare maximization as its point of reference. The economic assessment of legal rules is concerned about the outcomes of legal rules and it examines the expected effects of legal rules on the behaviour of the affected parties.

Mandatory rules are accepted regulatory means to overrule individuals’ own preferences where they remedy market failures created by information asymmetry, behavioural limitations or externalities. These rules allow consumers to invalidate contracts or make certain contracts automatically void. For example, product safety standards or interest rate ceilings in consumer credit contracts are provisions consumers cannot contract out.

The question legislators of consumer rules have to consider is which pressure, threat and ignorance should trigger intervention and whether mere disclosure rules or mandatory standards or strict mandatory rules should be legislated. The fundamental dilemma is to strike the “right” balance between default and mandatory rules. The relationship between mandatory and default rules is characteristic of a given private law system and illustrative of its underlying economic model. The different models of consumer protection are determined by this fundamental relationship between state intervention and free market forces. The distribution of responsibilities, i.e. rights and obligations between the state, individual consumers, consumer organizations and lobby groups, as well as suppliers and their organizations, is illustrative of the different models of regulatory policies. These models are based on different degrees of intervention and accordingly contain different combinations of market-conforming, market-complementary and market-corrective tools (Reisch, 2004).

However, economic analysis has its limitations in consumer protection as there might be overriding social interests that justify derogations from economic calculations and because it is difficult to quantify the benefits of consumer regulation, for example, when health and safety issues are at stake. Still, economic assessment draws the legislator’s attention to the financial consequences of legal rules, tries to drive legislative choices towards cost-efficient solutions and to avoid excessive regulation (Ramsay, 2003). A valuable message from economic analysis is that consumer protection comes at a cost (Hartlief, 2004). Mandatory allocation of risk, mandatory disclosure duties and other obligations will create additional costs for producers and sellers, who
will pass these costs on to consumers where possible. A further concern of
cost-blind consumer protection is that it can undermine the individual respon-
sibility of the consumer and may encourage careless behaviour. Moreover, it
can encourage consumer moral hazard problems, implying that consumers
take advantage of certain obligations imposed on firms and professionals. An
dexample might be buying a certain good from a doorstep seller with no inten-
tion of keeping the product after the cooling off period and using it during this
period.

2.1 The Economics of Information

“The economics of consumer protection is the economics of information”
(Shapiro, 1983). The relevance of information as an independent economic
good and as the focus of regulatory policies has been already recognized by
neoclassical economists. The economic considerations of information have
shaped the perspective of consumer protection from the theory of exploitation
(Priest, 1981), which focused on power imbalances between suppliers and
consumers and identified competition problems as the main source of market
failures, to information failures that are also present in competitive markets.

The contribution of information economics to consumer policy lies in
discussing the special features of information as an economic good and inform-

ation asymmetries as the main source of market failures. Its investigation is
focused on the behavioural patterns of market players under conditions of
imperfect information. In contrast to the neoclassic model, information is
analyzed as an independent good, whose production and acquisition can be
costly and where costs can be unequally distributed among market participants
(Akerlof, 1970; Stiglitz, 2000). The main insight of this stream of economics
was that asymmetric information in markets leads to adverse selection and
moral hazard and forms the basic tenets of consumer regulation (Stigler, 1961;
Nelson, 1970; Akerlof, 1970). When asymmetric information prevents the
provision of an efficient quantity and quality of information, rational
consumers will strive for an optimal degree of information under the rationale
of cost-benefit calculations (Beales et al., 1981).

As mentioned above asymmetrical information structures will not necessar-
ily lead to governmental intervention. Rather, a multitude of market-based and
governmental mechanisms are available to remedy the problems of adverse
selection and moral hazard. Market solutions such as signaling and screening,
long-term relationships, consumer learning and providing information through
instruments of comparison can also correct information asymmetries. When
these market mechanisms fail to work and market players behave opportunisti-
cally, government regulation is necessary when suppliers do not have an incen-
tive to pass on their knowledge in a complete and trustworthy manner.
The assumptions of informational economics, however, treat key aspects of consumer decision-making as exogenous and address only those particular problems of consumer decisions associated with imperfect information. In neoclassical economics the consumer is regarded as a sovereign, rationally performing market player who is aware of his needs as well as how he can satisfy those needs. In other words, consumers have rational preferences, consumers maximize their utility and act on the basis of complete information. In accordance with rational choice theory, consumer behaviour is thus determined by individual income, apparent and transitive individual preference orders, as well as the goods available, along with their prices.

It has been argued that a wider analytical scope is needed in order to rethink the behavioural assumptions of rational choice theory as the basis of neoclassical and information economics, as well as to adequately analyze the institutional framework on which both producers and consumers base their decision-making (Rischkowsky and Döring, 2008). Accordingly, beyond neoclassical economics the law and economics literature of consumer protection relies on two other mainstream economic theories: behavioural economics and institutional economics. Informational economics provides insights into how information affects the dynamics of markets, the determinants of bargaining and drives regulatory approaches to consumer protection based on cost-benefit-based analysis.

Informational economics addresses information costs, but it neglects transaction costs. Institutional economics takes into account other positive transaction costs such as further market and government regulations that influence the use of the market mechanism. Institutional economics extends the discussion to the formal and informal institutions which control social interaction and shape individual behaviour so that negotiation and coordination costs are reduced (Rischkowsky and Döring, 2008; North, 1990). New institutional economics analyzes institutional arrangements that aim to remedy market failures that are the result of imperfect information. In other words, it is not imperfect information only that influences the efficiency of the market mechanism. This stream of economics also deals with the problem of the opportunistic behaviour of contract parties (Williamson, 1975) and draws attention to solving information asymmetries through designing efficient contracts or institutions. It points to the economic consequences of existing transaction costs, such as costs of initiating and bargaining over transactions, and as such it provides a more complete concept of transaction costs.

2.2 Behavioural Economics

Traditionally economists rely on the invisible hand of market mechanisms and the rational choice theory to predict consumer and seller behavior. These
foundations, however, have been challenged by the empirical observations of behavioural economics. This stream of economics points to the institutional constraints on individual choice by showing how individuals make decisions and respond to law and policy. These insights into the decision-making process of individuals prove that the predictions based on traditional rational choice theory often do not hold. Behavioural economics demonstrates that consumer decision-making is affected by several biases and heuristics. Biases and heuristics, such as bounded rationality and information overload, risk perception biases, self-serving biases, status quo biases, time-related biases, contexts and framing, anchoring and adjustment, and bounded will-power make individuals deviate from rational choice.

Behavioural economics deals with these endogenous aspects of consumer decision-making and provides empirical evidence on consumers’ imperfect information-processing skills. Empirical research shows that consumers either do not use the information at their disposal or only do so in a limited way (Kahneman and Tversky, 1979).\footnote{Kahneman and Tversky present a critique of expected utility theory as a descriptive model of decision-making under risk and develop an alternative model, which they call prospect theory. Kahneman and Tversky found empirically that people underweight outcomes that are merely probable in comparison with outcomes that are obtained with certainty; also that people generally discard components that are shared by all prospects under consideration. Under prospect theory, value is assigned to gains and losses rather than to final assets; also probabilities are replaced by decision weights. The value function is defined on deviations from a reference point and is normally concave for gains (implying risk aversion), commonly convex for losses (risk seeking) and is generally steeper for losses than for gains (loss aversion). Decision weights are generally lower than the corresponding probabilities, except in the range of low probabilities.} Behavioural economics points to the relevant determinants of search, acceptance and the processing of information. For example, increasing the rationality of purchase decisions given additional information itself seems, therefore, to be subject to specific constraints. The individual capacity for accepting and processing information can be emotionally controlled and as strongly influenced by environmental stimulants (Kahneman, 2003; Loewenstein, 2000).

The relevance of behavioural economics for consumer protection lies not only in the fact that consumers are inhibited from rational decision-making by biases and heuristics, but also that sellers are able to take advantage of consumers’ reduced capabilities. Behavioural insights imply that government interventions might be justified even in competitive markets in order to help consumers in their decision-making, for example, by decreasing available options. Information disclosure, one of the most preferred government interventions in consumer protection policy, needs to be reassessed in the light of
behavioural biases. As mentioned above the economic literature is critical of state interventions, as it is argued that individuals are in the best position to know their own preferences and act accordingly. As a result, regulatory approaches implementing behavioral economics have been developed that leave free choice uninhibited: soft paternalism.\(^2\) Soft paternalism nudges\(^3\) individuals into welfare-enhancing decisions without imposing a particular choice on individual consumers. When biases, heuristics and non-rational influences on behaviour render individual consumer decision-making suboptimal, such light-handed intervention strategies can be designed to enhance these decisions. Individuals can be de-biased and nudged into rational decisions by for instance providing less and better information. Choice strongly depends on the context, the alternatives that are provided and the presentation of the various options. These factors represent so-called “choice architectures” framing consumer decision-making (Thaler and Sunstein, 2008; Luth, 2010).

Beyond the research results and policy implications of behavioural economics, one should consider that additional information only receives consideration when consumers are motivated to receive and to process this information. Apart from the assumption that consumers are capable of conducting optimal search and processing behaviour, the implicit assumption within the economics of information states that they are also intrinsically motivated to exercise an information search or to receive offered information. Empirical studies, however, show that engagement in an active information search depends decisively on the degree of personal involvement (Kroeber-Riel and Weinberg, 2003; Weinberg, 1981).

3.  ECONOMIC MODELS OF CONSUMER BEHAVIOUR

The economics literature primarily relies on rational choice theory. Rational choice theory is a coherent theory of human decision-making, which starts from the presumption that consumers have transitive preferences and seek to maximize the utility that they derive from those preferences. Choice is considered to be rational when it is deliberative and consistent and reasonably well-suited to the attainment of the goals of their choices (Ulen, 2000). Individuals

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\(^2\) There are several names for this regulatory approach. Lighter-hand intervention (OECD, 2006), asymmetric paternalism (Camerer et al., 2003) or libertarian paternalism (Sunstein and Thaler, 2003).

\(^3\) “Nudges” is an acronym which stands for six subtle methods for improving choice, devising a good choice architecture: Incentives, Understanding mappings, Defaults, Giving feedback, Expecting errors, and Structuring complex choices (Thaler and Sunstein, 2008).
are assumed to be the best judges of their own welfare, often referred to as consumer sovereignty. Consumers are sovereign in the sense of being able to define their needs concerning goods and services, to signal their needs to the market and to the producers and to satisfy those needs at a reasonable price and by choosing good quality. Consumer sovereignty is actually a “set of societal arrangements” that makes the economy respond to the messages consumers send out to other market participants about their needs. Thus it is the power to decide about producers’ success or failure through the exercise of consumers’ freedom of choice (Lande and Averitt, 1997). It is a normative standard against which the performance of markets can be judged. The market rules should guarantee that consumer preferences ultimately control the process of production (Kerber and Vanberg, 2001). Consumers know their own preferences and needs the best, while regulators may not be able to protect them properly. Social norms such as reputation and repeat sales are regarded as an effective market policing tool, while government protection would create substantial costs for producers and eventually for consumers.

The empirical findings of behavioural economics challenged these assumptions by explaining what people actually do, how consumers analyze, interpret and use product and service information. Behavioural economics found that consumer preferences fluctuate depending on the situation in which they have to make their decisions. Individuals lack the ability to build constant and reasoned preferences because they are influenced by the context and because they exhibit certain cognitive errors related to time or memory or simple miscalculation. Consumer behaviour is context dependent and the form, context, quantity and substance of information have an impact on the ability of individuals to assess that information (Smith and King, 2007). Consumers will only look for and process a certain amount of information. As a consequence, individuals fail to maximize their welfare under specific circumstances (Korobkin and Ulen, 2000) and they take short cuts when making decisions leading to choices that might be inconsistent with promoting their own welfare.

Behavioural economics argues that the capacity of the human mind to conceive and process complex information is relatively limited and that consumers systematically fail to deal with information even in situations where the market provides the socially optimal amount of information or it distributes it efficiently. Behavioural economics identifies behavioural biases as market failures and suggests remedies aimed at framing effects and thus steering consumers’ choices towards welfare-enhancing options (Sunstein and Thaler, 2003). Paternalistic guidance towards certain options through framing the way information is provided could assist consumers to de-bias their decision-making and to channel their decisions to socially beneficial options (OECD, 2006).
While recent research in behavioural economics has identified a variety of decision-making errors that may expand the scope of paternalistic regulation, it does not provide solid evidence to support a return to paternalistic regulation (Jolls et al., 1998; Ulen, 2000; Thaler, 1980). The evidence is not yet conclusive with regard to its impact in real world consumer markets. The costs and benefits of such paternalistic regulation in the long run do not justify more government intervention but rather reaffirm the findings of neoclassical economics and rational choice theory. A more cautious regulatory approach might be to consider the question whether cognitive biases impede competition and prevent market forces from performing efficiently even when consumers are suboptimally or completely uninformed. The answer to this question significantly influences the need to introduce market-correcting regulatory measures (Gomez, 2006; Wright, 2007).

State (paternalistic) regulations based on the findings of behavioural economics may lessen consumers’ incentive to engage in learning and developing rational behaviour or even intensify irrational behaviour by introducing moral hazard. It is argued that consumers become aware of their biases and learn from their mistakes. Epstein argues that competition, learning by consumers and the education of sellers by consumers will drive out consumer errors (Epstein, 2006). People learn from their mistakes and once they are confronted with the detrimental consequences of their previous decision, people improve their biased decision-making and are then able to choose a more beneficial option when a similar situation arises. The learning effects increase the more standardized the product is (whether that product is a good, a service or digital content) and the more frequently transactions occur. Kelman argues that learning effects will cause irrational behaviour to disappear over time; people should therefore be allowed to make their own mistakes. Accordingly, relying on consumer learning could be a very effective and efficient instrument to support consumer welfare (Kelman, 1998). However, whether consumers are in fact able to learn from their mistakes or can be educated to employ improved decision-making strategies depends on several factors such as feedback, spill-over effects, the cost of education and the ability to improve the decision based upon the mistake. Also, the size of the consequences might prevent learning and correcting mistakes (Luth, 2010).

Still, it is in such situations that sellers are able to take advantage of consumers’ welfare-decreasing decisions. If consumer decision-making is indeed constrained by biases and heuristics, the question is whether sellers respond strategically to these biases. In order be able to respond to them, sellers need to be aware of the biases and heuristics and they need to be able to take advantage of biased consumer decision-making. Sellers could overcome consumer biases by education or lowering switching costs. Firms can still
intervene in various ways in consumers’ learning process by, for example, bundling products, creating artificial non-standardization or multidimensionality (Bar-Gill, 2007).

3.1 The Notion of Consumer

The notion of the consumer, on the one hand, illustrates well how law and economics can channel a more effects-based approach into the legal assessment of consumer protection. On the other hand, this notion forms the inner definition of who can rely on consumer protection rules and thus represents the underlying regulatory model. The notions of “consumer” and “professional” vary across jurisdictions and also among, for example, the different EU law Directives. The question is whether these concepts should be widely or narrowly construed. The narrow notion defines consumers as natural persons acting for purposes outside his trade, business or professions, and professionals are defined as persons (legal or natural) acting for purposes related to their trade, business and profession. In the academic Draft Common Frame of Reference (DCFR), a wider concept of consumer and a corresponding notion of business are opted for.

In the recent law and economics literature, a new approach has been proposed. The notions of consumer and producer should correspond to the market failure addressed by consumer policy, namely information asymmetry. Focusing on being a natural or a legal person and on the purpose of the contract are not adequate proxies for singling out those situations where consumer protection is warranted. Of course, both elements need to be present in order for a party to be considered a consumer for the application of these regulations (Cseres and Luth, 2010). The personality of the parties, being natural or legal, is relevant for assessing whether a party should be considered a consumer. Only natural persons can be considered consumers. However, legal persons can also lack information with respect to the main subject matter

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4 In December 2007 the Draft CFR, which has been prepared by academics, was published. In many respects, the DCFR looks like a European Civil Code without family law, succession law and company law. It is clear that the Commission is not only proposing to improve the quality and structure of the present consumer acquis, but at the same time it is aiming at the adoption of a “single, simple set of rights and obligations Europe-wide”, a horizontal instrument which is in fact equivalent to a European code of consumer or contract law. The DCFR contains principles, definitions and model rules of European private law as distilled from the acquis communautaire of contract law and the private laws of the Member States. It covers both general contract law rules as well as specific ones such as rules of consumer contracts.

5 Definitions are given in Annex 1, which is referred to in article I.–1:103 (1) of the DCFR.
of transactions and thus they may be eligible for the application of consumer protection legislation. Focusing on the personality of the parties as a proxy might lead to both so-called type I and type II errors, granting consumer protection where it might not be necessary to overcome information problems (type I error), and withholding consumer protection from parties that do suffer from information asymmetries in contract situations (type II errors).

It is argued that the notion of consumer should correspond to the market failure addressed by consumer policy, namely the information asymmetry between the parties to the contract and not the personality of the consumer as it is often the case now. Accordingly, the definition would focus on the issue of whether a party – the seller, producer – has or is supposed to have information or knowledge with respect to the main subject matter of the contract, whereas his counterpart to the contract – the consumer – does not. Therefore, whenever a party, natural or legal, is acting outside the field of his professional competences with respect to the subject matter of the contract, whereas his counterpart is not, the first party should be protected by consumer protection rules. Lacking professional competences, skills and expertise vis-à-vis a contract partner implies being subject to information asymmetry. This reasoning would argue for a wide definition of consumer based on concerns related to information asymmetry. The definition of consumer and professional could thus be widened to contain all situations in which the seller has an information advantage over the consumer (Cseres and Luth, 2010).

Aquaro suggests the following definition: Consumers could be defined as: natural or legal persons operating in a field external to their professional competences, skills and knowledge with respect to the subject matter of the contracts (Aquaro, 2003). This definition also incorporates corporate bodies and companies who act outside their field of expertise and therefore possibly lack relevant information in comparison with their contracting partner. Information disadvantage is widely acknowledged as being one of the primary reasons for protecting consumers, alongside lack of bargaining power. Such a definition can also capture situations of mixed contracts, when two professional parties conclude a contract, one of whom is acting outside the field of his profession, for example, a general practitioner buying a car to use both professionally, when visiting patients, and privately. Although the general practitioner is clearly a professional, he lacks information about the quality of the car and lacks skills to easily assess this quality, as he or she lacks information about other aspects of the contracts about which his counterpart, the professional car salesman, will possess information. When the general practitioner enters the car purchase contract, he does not differ in his decision-making mechanism from consumers. Moreover, the information asymmetry that creates a market failure to the detriment of consumers would continue to exist even if the general practitioner were to buy a car for professional use.
only. The same general practitioner could also buy a car with the sole purpose of using it to visit his patients. This does not alleviate the information asymmetry the doctor is subject to vis-à-vis a professional car salesman. Consumer protection rules as a means to overcome adverse selection should apply in this situation when taking an economic viewpoint (Cseres and Luth, 2010).

3.2 Vulnerable versus Average Consumers

Nowadays many consumer laws differentiate between average and vulnerable consumers, consumers who are at a particular disadvantage. It has been argued that if the legal concept fails to differentiate between categories of consumers or to analyze the extent of their vulnerability, this may lead to both over- and underprotection, since the law has to work with a model of the average consumer and restricts protection of the vulnerable to extreme situations.

However, differentiating between the average consumer and the vulnerable consumer has also raised fundamental questions for both consumer policy making and consumer legislation. First, what kind of legal, economic or political arguments form the basis for justifying such a differentiation. What constitutes vulnerability? What interpretation of the terms vulnerable and disadvantaged should be applied for the purposes of consumer policy? Are the needs of vulnerable and disadvantaged consumers best met through generic approaches that give scope for discretion in application, or through more targeted mechanisms (Productivity Commission, 2008)? Does enforcement of this particular provision depend on the nature of the product and service at stake, the age, education, mental state or are other criteria decisive? What are the normative implications of this differentiation? Should the government be active and interventionist on behalf of consumers or should the state role be restricted to regulating the marketplace for products and services? If vulnerability lies in the increased difficulty of obtaining and processing information, then what kind of remedy can allow vulnerable consumers to make an informed choice? Can the disclosure of more information be a remedy? Or is the way information is disclosed a proper tool?

An even broader question is whether consumer policy is necessarily the best way of assisting those in the vulnerable and disadvantaged group. Thus, for example, the costs of more stringent labelling requirements to meet ‘right to know’ goals will be passed on to all consumers – some of whom may derive little benefit from the information provided (Productivity Commission, 2008).

In (behavioural) economics, a distinction is made between rational consumers and bounded rational consumers. This distinction can better take account of both the cost-benefit advantages of adopting a rational behaviour model, where consumers act in their best self-interest as well as of behavioural biases when consumers systematically depart from the rational model and
when regulations might be ineffective. The dilemma, however, with regard to this distinction is the following. While to the extent that the cognitive errors identified by behavioral research lead people not to behave in their own best interests, paternalistic interventions by the government may prove useful. But, to the extent that such intervention prevents people from behaving in their own best interests, paternalism may prove costly (Camerer et al., 2003). Accordingly, the dilemma is how to help boundedly rational consumers to avoid making costly mistakes, while at the same time causing little or no harm in terms of minimizing costs to rational people. One solution would be to implement a regulation, which corresponds to what Camerer et al. call asymmetrically paternalistic: “A regulation is asymmetrically paternalistic if it creates large benefits for those who make errors, while imposing little or no harm on those who are fully rational. Such regulations are relatively harmless to those who reliably make decisions in their best interest, while at the same time advantageous to those making suboptimal choices” (Camerer et al., 2003).

Another solution is to rely on learning effects. Ekstrom and Ward show examples of “reverse socialization” in the direct skill transfer involved in learning to search, for example, the internet for information which involves direct influences (e.g., child-parent transfer of knowledge); and examples of “retroactive socialization” in the indirect skill transfer process which involves indirect influences (e.g., child-parent transfer mediated via media, peers) (Ekstrom, 1995; Ward, 1974).

These learning processes point in the direction of something other than direct regulation; they in fact illustrate the significance of consumer education for digital competences. Consumer education could target deep-level learning; beyond simple memorization, it requires a significant degree of cognitive processing of material. This might also address the concerns raised in behavioral economics. For example, digital competence is now as important as reading, writing and arithmetic, thus consumer education can in fact be an effective complement to regulation (OECD, 2008).

There are important differences in defining and legislating vulnerability across jurisdictions which are affected by different cultural, institutional, legislative, legal, and historical frameworks and which distinguish different relationships between the individual and the state. It is clear that future legislation could target refining and perhaps standardizing the understanding of vulnerability. Achieving a more nuanced understanding of consumers’ vulnerability across industry, service, and national contexts might incorporate typologies such as that of Morgan, Schuler and Stoltman’s “consumer-situation typology of vulnerable consumers … [that] includes four consumer groups (physical sensitivity, physical competency, mental competency, and sophistication level) and five situational alternatives (material environment,
decision maker, consumption interval, usage definition and temporary conditions) … [and which] illustrates that consumer vulnerability arises from the interaction of a person and all of his or her personal characteristics with a consumption situation.” (Morgan et al., 1995).

4. REGULATORY TOOLS

4.1 Information Disclosure

As emphasized above, the economics of consumer protection is largely concerned with the economics of information. When consumers are sufficiently informed about possible market failures and can protect themselves, the role for government regulation decreases. Information about price, quality and other elements of a transaction allows consumers to enter efficient contracts and information disclosure encourages sellers to compete on price and quality (Beales et al., 1981).

The economic strength of information disclosure is that it can cure information asymmetries and assist consumers in their decision-making process, while leaving market processes and the private autonomy of market players untouched. A clear benefit of information provision as opposed to, for instance, mandatory quality standards is that it will not lead to a decrease in choice and it encourages the individual responsibility of the consumer. The choice between mandatory rules of substance and mere information disclosure should be clearly linked to the underlying costs and benefits of those choices.

Substantive mandatory rules restrict the variety of products and contractual conditions. Information rules, even if they are mandatory, do not restrict variety and leave the substantive choice of contract contents to the parties (Grundmann et al., 2001). Moreover, restricting freedom of contract at the same time curbs a learning process, in which contracting parties discover the optimal form of contracting for their purposes on the basis of their individual preferences.

The implications for consumer protection differ in the case of neoclassical economics and behavioural economics. Neoclassical economics focuses on market failures originating from information failures. It identifies the sources of information deficiencies and thus consumer harm as being either lack of competition or the fact that information is unavailable or not costless or where there is uncertainty of individuals about the quality of product characteristics. These information problems can be solved through uninformed consumers’ screening or sellers’ signalling (Wein, 2001; Kerber and Vanberg, 2001). Reputation and brands as signals of quality can, however, act as barriers to new entrants and decrease competition. Product comparison modalities like
reviews on the internet can considerably decrease information search costs, enabling increased competition and the benefits from that competition may flow to consumers but may at the same time facilitate collusion among firms. Information asymmetry should not be solely offset by regulating the mandatory provision of information. The search costs of gathering and evaluating more information to improve a decision about buying a product or service have to be weighed against the benefits of that added information. When consumers think the costs of searching for information do not outweigh the benefits they will not act (Gomez, 2008). This phenomenon is called rational apathy, which is often a reason for consumers’ inaction.

Neoclassical economics encourages more and better information to remedy market failures on the demand side, such as mandatory disclosure or third-party certification. However, more disclosure may conflict with competition policy as it might lead to collusion and it may not be as useful for consumers either.

Behavioural economics argues that the capacity of the human mind to conceive and process complex information is relatively limited. Consumers may rely on heuristics instead of being guided by rationality and they fail to deal with information even in situations where the market does not have difficulty in producing the socially optimal amount of information or in distributing it efficiently (Ulen, 2001). In these situations, consumer harm is a result of behavioural biases. These biases can take many forms such as misunderstanding small probabilities, pseudo-certainty, hyperbolic discounting, overconfidence, default bias, decision conflict as a result of information overload. In case of inertia, people are unable to process complex information and take irrational decisions. Or the oversupply of information may be counterproductive and may reduce market transparency, a situation referred to as “confusopoly” (Gans, 2005). Even when comparative information is available to consumers, this inertia may be explained by computational difficulties, perceptions that search costs are high, or possibly by misplaced trust in consumers’ present supplier (Wilson and Waddams, 2005).

The problem of framing biases, “choice architectures”, emphasizes the relevance of the specific ways in which objective information is provided. Behavioural economics suggests “lighter hand” interventions (OECD, 2006) in the form of remedies aimed at framing effects and thus steers consumers’ choices towards welfare-enhancing options (Sunstein and Thaler, 2003). Paternalistic guidance towards certain options through framing the way

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6 In behavioural economics, hyperbolic discounting is a time-inconsistent model of discounting (Ainslie, 1974).
information is provided could assist consumers to de-bias their decision-making and to channel their decisions to socially beneficial options (OECD, 2006). For example, certification systems, trustmarks or codes of conduct could provide advantages over direct government regulation, although many rely on some form of endorsement or oversight by government to be effective and credible.

For example, a model of standard terms that enhance welfare for the majority of consumers might be more efficient in providing protection to consumers. Empirical research indicates that individuals stick to the default rule provided. The default rule could be expressive in that it is interpreted to be the fairest allocation of risk simply because it is drafted in the standard term model form. A default risk allocation in the model standard form could provide the consumer with a reference point, from which he is more reluctant to deviate to the risk division he would have had in mind absent the default.

In the following sections, specific examples of information disclosure will be discussed. First, law and economics of formation of contracts, then right of withdrawal and unfair contract terms will be assessed.

4.2 Formation of Contracts

The formation of contracts touches upon the transparency, comprehensibility, availability and validity of standard contract terms and the confirmation of the existence of contracts by business. There is a vast amount of law and economics literature on standard form contracts and surely the debate about the optimal judicial control of contract terms is far from conclusive. The early law and economics literature first concentrated on unequal bargaining power and the inability of consumers to bargain over terms.

However, later it was argued that, other things being equal, sellers prefer to extract their bargaining advantages by increasing price rather than reducing the value of the contract to consumers (Posner, 1992). Therefore, even a monopoly would allocate the rights and risks in a contract efficiently. Accordingly, the emphasis has shifted to the information problem and the problem of signing without reading and understanding the implications of each term. Goldberg argued that since contract terms are often unnoticeable, sellers are encouraged to offer low quality–low price contracts (Goldberg, 1974). What’s more, cognitive deficiencies prevent consumers from fully internalizing the costs of many terms, even if they know and understand them (Cruz and Hinck, 1996; Hillman and Rachlinsky, 2002; Korobkin, 2003). It is believed that information asymmetry pushes sellers to offer inefficient and disadvantageous terms to consumers.

The legal problem is as follows. Consumers often choose to free ride on the efforts of other consumers. Consumers assume that others assess the standard
terms and thus they do not need to incur any costs themselves, relying on and benefiting from other consumers’ reading of the standard terms. This provides a disincentive for consumers to start assessing standard terms. Also, consumers feel protected by courts and regulators from unreasonably onerous terms. Most scholars agree that standard terms in consumer contracts are not read, even by informed consumers who form a sufficiently large group to induce welfare-enhancing standard terms (Hillman and Rachlinsky, 2002). To what extent improving the readability and intelligibility of standard terms can solve this problem is also unclear, as the costs of reading, interpreting and comparing several standard forms remain high (Becher, 2007). Consumers are subject to rational apathy: they do not read or interpret all contract terms, but pay attention to the salient product attributes. It is therefore in the best interest of businesses to offer non-salient standard terms at as low a cost as possible, enabling a price reduction.

Moreover, consumers lack the skills and capacities to include more than just a few salient product attributes, such as price, colour, type, warranty period, in their decision-making process. Some of these salient product attributes may be individually negotiated terms. Since consumers are not able to include non-salient standard terms in the decision-making process, severe doubt can be raised as to whether these standard terms will be welfare-enhancing (Korobkin, 2003). A welfare-enhancing contract term would allocate risk to the party that is most able to influence whether that situation occurs and would place responsibility for certain actions with the party that is most able to induce them at lowest cost. Furthermore, it should correspond to the risk preferences of the parties to the contract. For example, a contract term regulating the standard period for delivering a household appliance to the house of a customer could lay down that the store should be notified in writing within three days. Many consumers might prefer to have this term extended to seven days, even when that implies incurring a small cost for the extension of the time frame. However, since this term will not be read by consumers nor is salient to consumers, the seller is able to draft a term with a short time frame for notification. Prolonging this time frame could result in more notifications of delivery to the seller, and therefore be more costly to the seller. Providing a short time frame for notification is less costly to the seller, enabling the seller to charge a lower price for the good. Competition between businesses for the favour of the consumer only affects salient product attributes. As price is a salient product attribute, competition between businesses induces the price to be set at a competitive level. A standard term regarding notification duties in case of damages caused by the delivery service will just be provided at low cost and low quality, regardless of actual consumer preferences. The latter term will be one-sided, favouring the seller and not the consumer, but not necessarily welfare enhancing.
Standard form contracts in consumer transactions are usually not read by consumers. The phenomenon of “signing without reading” of contracts gives opportunities for the drafters to engage in unfair trade practices (Ben-Shahar, 2009). Various doctrines of contracts and consumer protection law have addressed this problem, most recently the DCFR and the American Law Institute considering principles for software contracting. The recent proposal for reform is to give individuals a more substantial opportunity to read the contract before manifesting assent. It is believed that this greater opportunity to read will encourage more transacting parties to read the terms and assent to the contract will be more meaningful (Ben-Shahar, 2009).

Ben-Shahar argues that focusing on providing consumers with an opportunity to read is useless, and may even be potentially harmful. He argues that most likely, greater opportunity to read would not produce greater readership of contracts, at least not the type that can help people make informed decisions. The problem with this solution is that it does not improve the terms the contracting party gets. Improving the legal quality of the transaction does not rely on readership. The availability of terms in advance or after the transaction, in browsewrap or clickwrap, does not change the behaviour of those consumers who do not read standard terms and, even more importantly, does not improve the content of the transaction (Ben-Shahar, 2009). For example, empirical research shows that there is no difference in content between terms in software licence agreements whether they are the terms in the contracts that were available to read prior to the sale and payment or that are “shrinkwrapped” and are not available until after the sale. Marotta-Wurgler’s research shows that when the terms come after the payment they are no worse, and in fact might be slightly better (Marotta-Wurgler, 2009).

In fact, as Hillman shows, a more meaningful presence of an opportunity to read might eliminate a procedural flaw in assent and might make it harder for courts to make a finding of procedural unconscionability (Hillman, 2007).

A recent US court decision illustrates that the chance that a consumer will be rescued ex post from an oppressive term through the filter of the doctrine of unconscionability is incrementally diminished when the ex-ante protection accorded by an opportunity to read is perceived to be stronger. In Riensche v. Cingular Wireless, the court rejected the unconscionability claim because the

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7 ALI principles of software contracts sections 2.01 (c) (1), 2.02 (c) (2). The ALI principles in fact deal with the problem of shrinkwrap contracts and just like the US case law on browsewrap contracts, they put the main emphasis on the opportunity to read contracts in order to assess whether parties gave their assent to the contract. ALI Principles, at 130–131, 149. The leading US case is Specht v. Netscape, 306 F3d 17 (2nd Cir 2002).
consumer had unlimited time to review the arbitration clause and thus a reasonable opportunity to understand the term. While legal concepts and the courts’ approach differ in Europe, these insights carry an important message for law making.

The basic tenet that Ben-Shahar puts forward is that disclosure should be restricted to minimal information that is relevant and essential. In other words, information devices that aggregate basic data about contracts and place a minimal burden on consumers prove effective regulatory means. He puts forward two such methods: rating of contract terms and labelling of contract terms. He proposes to apply the traditional market practice that allows consumers to conduct price/satisfaction predictions by rating the quality features of goods and services. Rating scores could also aggregate some relevant aspects of contract terms (Ben-Shahar, 2009). Similarly, a labelling regime could develop easily readable formats of the most salient contract terms summarized and uniformly presented (Ben-Shahar, 2009).

De Geest and Kovac drafted a concise list of the main findings in law and economics on the formation of contracts that address information obligations (De Geest and Kovac, 2009). They propose an optimal doctrine of duty to inform in five steps: the least cost information gatherer should produce and communicate information, the information should not be communicated if the other party has it already, information should not be communicated if the communication costs exceed the value of the information, there should be no duty to reveal entrepreneurial information, the information does not consist of mere opinions and other non-falsifiable statements (De Geest and Kovac, 2009).

4.3 Right of Withdrawal

Cooling-off periods are legislated to cure consumers’ irrational decision-making, situational monopolies and information asymmetries in an environment of incomplete information and high pressure marketing. Consumers can

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9 This is also in line with what Grundmann proposed: making only the most material information available, information that would improve consumers’ decisions and to have it provided by the cheapest information supplier.
10 The least cost information gatherer is the party who can obtain the information at a lower cost than the other party. This concept has been developed by Kronman (Kronman, 1978b).
11 Entrepreneurial information is costly to produce and hard to be compensated for once it has been revealed. De Geest and Kovac, 2009, p.117; Kronman, 1978b; Goldberg, 1989.
make suboptimal decisions when they face temporary market power. Cooling-off periods provide consumers with time for reflection, to process all the relevant information, search for additional information or advice and establish whether the agreement indeed reflects their individual preferences.

Cooling-off periods can serve as an effective remedy in case of asymmetric information related to credence or experience goods such as digital content contracts. Businesses might not have an incentive to reveal relevant information about the quality of their goods either because it is costly or because it does not correspond to the price. Cooling-off periods can then ensure that businesses set prices that correspond to the real quality of a product because when a consumer experiences the price of the good not to be in correspondence with the final quality, he can make use of his right to withdraw. The producer as a result will be induced to set a price that corresponds to the real quality.

Cooling-off periods may also address consumers’ cognitive constraints in transactions. In this case, cooling-off periods provide consumers with extra time to reconsider their short-term preferences and rebalance with their long-term preferences. Cooling-off periods thus as the costs of “regret contingency” (Goetz and Scott, 1989). Consumers can make suboptimal decisions when they face temporary market power in the case of high pressure marketing.

Accordingly, the costs of cooling-off provisions should be considered. Consumers may engage in opportunistic behaviour by using the product during the cooling-off period and then returning it to the seller claiming bad quality. Cooling-off periods delay transactions, create uncertainty and thus increase transaction costs. Such a mandatory provision will raise the prices of the products and services at stake and it can be realistically assumed that such costs will be passed on to consumers.

Moreover, granting withdrawal rights reduces the need for information disclosure requirements. When consumers as the cheapest information costs providers can obtain the relevant information themselves during the cooling-off period, businesses should not be required to provide the same information. These extra information provisions only increase the costs of the transaction and thus the costs for consumers. This is, for example, the case in the EU Doorstep Selling Directive, where businesses have to provide the information prior to and after the conclusion of the contract.

A further negative side effect of a cooling-off period may be that the contract goods can devalue when the consumer has the opportunity to directly possess them. This is a relevant issue for digital content contracts as they do not even weigh up to the standard case of using a car for a couple of days then cancelling the contract after those days; the seller is not able to sell the car again as ‘brand new’. This could be an argument not to award a right of with-
drawal, or to exclude the right of withdrawal once performance by the trader has taken place.

Further associated costs are the costs of proceedings, which have already been started, costs related to the re-wrapping of goods, a decrease in value after return and insurance premiums.

The law and economics literature argues that withdrawal rights should be granted when they can counteract the performance of inefficient consumer contracts (Eidenmüller, 2011). Due to irrationality or impairment of will formation, consumers may enter into contracts that cost more than their benefits. However, the cost-benefit analysis of withdrawal rights in fact has to take account of the learning effects that exist when consumers enter inefficient contracts (Eidenmüller, 2011).

Accordingly, right of withdrawal can be an example of a cost-blind consumer protection that may undermine the individual responsibility of the consumer and may encourage moral hazard, implying that consumers take advantage of certain obligations imposed on firms and professionals. When cooling-off periods are too long, they invite moral hazard and raise transaction costs as a result of delay and uncertainty of transactions. Van den Bergh and Rekaiti argue that in certain cases the prescribed period should be longer where the economic distortion cannot be remedied within that period, an example being the case of timesharing. They also suggest the introduction of monetary compensation, a rental payment in order to avoid consumers abusing the right of withdrawal. This implies that during the cooling-off period the consumer will have to pay a kind of rental payment proportional to the time he possessed and used the goods, as well as the costs incurred by the seller from that use. Passing those costs onto consumers will deter them from behaving opportunistically, because they know their behaviour will not be without costs (Rekaiti and Van den Bergh, 2000).

A compulsory cooling-off period can have further adverse effects. For example, a cooling-off period with severe sanctions against non-compliance and the high costs associated with it have the effect that businesses exit the market, which in turn will lead to a reduction of supply and higher prices. Thus, the optimal period of withdrawal strikes a balance between the information asymmetry the consumer faces and the opportunity for moral hazard.

In certain cases, the prescribed period should be longer where the economic distortion cannot be remedied within that period, which may be the case for timesharing. In order to avoid consumers abusing the right of withdrawal monetary compensation, i.e. a rental payment, could also be introduced (Rekaiti and Van den Bergh, 2000).

The number of contracts negotiated away from business premises is growing and thus this right might become a standard right. It is especially important to think about the question of what the consumer can in fact do during the
cooling-off period: collect more information? What can consumers do in let’s say an extra seven days that they could not do in the first seven days? Moreover, consumers’ preferences might be distorted by exogenous and/or endogenous factors. Eidenmüller argues that in the latter case a mandatory withdrawal right with regard to timesharing, credit contracts and life insurance contracts is justified. With regard to doorstep selling, endogenously distorted preferences justify mandatory withdrawal rights (Eidenmüller, 2011).

Law and economics is critical of piling up various information remedies such as cooling-off periods and information disclosure for the same contract. If the purpose of the cooling-off period is to offer consumers some time for reflection, one may wonder why business should also be burdened by all the disclosure rules? Where the cooling-off period serves to provide the consumer with some kind of experience with the product in order to make a final decision whether to buy or not, consumers are invited to behave opportunistically. The economic analysis suggests that making consumers conscious of the price of this added protection could make the cooling-off period more efficient and effective at reaching the aim it has been developed for. Eidenmüller argues that standardizing instructions on the existence of withdrawal rights and lowering the costs of these rights can increase their effectiveness (Eidenmüller, 2011).

4.4 Unfair Contract Terms

Standard form contracts are most problematic in consumer markets for mass-marketed goods, where sellers who act as repeat players can construct self-serving contract terms, but buyers who occasionally enter transactions cannot evaluate the value of such terms (Gillette, 2011). Standard contract terms are typical cases of asymmetrical information between sellers and consumers, which can lead to adverse selection and accordingly a decrease in the quality of contract terms. Asymmetrical information might be overcome by simple market mechanisms. However, when market solutions do not work, intervention through judicial control is justified. While competition law can control standard terms in cases of market power when prices are set above competitive levels, contract and consumer law interventions tackle information deficits related to the content and meaning of pre-formulated terms and the relative costs of reducing or insuring contractual risk. Katz argued that there was insufficient evidence to support the explanation of market power as a justification for controlling standard terms. Instead he identified the presence of asymmetric information as the main grounds for government intervention (Katz, 1998).

Standard contract terms have traditionally been assessed under a legal concept of fairness. However, unequal bargaining power, the take-it-or-leave-it nature and standardization of contracts have given rise to scepticism regard-
ing the fairness of standard terms. In neoclassical economics, competition between companies with respect to their standard terms should ensure a “fair” (welfare-enhancing) contract for all consumers. If consumers disagree with some terms, they could shop for better terms (Priest, 1981). As profit-maximizing businesses do not want to lose consumers, they will adapt their standard terms to correspond to the preferences of the majority of their customers. Consumers are considered to be in the best position to maximize their own welfare and to make conscious choice when they enter into contracts. However, the early literature assumed that standard contracts are linked to market failure in the form of inequality of bargaining power between the seller and the buyer. Accordingly, standard contracts were deemed to fail the concept of rational and conscious consumer choice that underlies the neoclassical basis for enforcement of contracts (Rakoff, 1983).

Information economics showed that standard terms form a clear case for government intervention on the basis of information asymmetry and adverse selection. Without judicial control, the probability of reaching this equilibrium price is low. In specifying the regulatory reason for judicial clause control, it is not superior market power, but rather entrenched information asymmetry which leads to detrimental deviations from the equilibrium price (Schäfer and Leyens, 2010).

Protecting weaker parties from exploitation by market participants with market power does not explain judicial control for standard terms. If customers have complete information about the allocation of risks, even a monopolist will not pass on such risk to the consumer which he can bear at a lower cost. Passing on risks against the cheapest cost avoider principle will result in a decrease in demand and a reduction of the producer surplus. Judicial clause control is to avoid information asymmetries between the parties. The party who receives standard terms will typically not be willing to incur the information cost of reviewing them, given the limited gain expected from that operation. This is because the cost of acquiring information regarding the contents of standard terms routinely exceeds the anticipated gain. It is therefore rational to ignore the clause contents. As a consequence of this, rational ignorance competition among issuers of the best contract terms will fail. The users of standard terms will rather engage in a competition for the most unfair terms, which has the effect of a race to the bottom (Schäfer and Leyens, 2009).

12 The legal-political starting point with regard to standard terms ought to be the equilibrium price, which reflects that distribution of contractual risks between the producer and the customer that minimizes the sum total of all costs of risk. This implies that the equilibrium price should include all contractual risks for which the producer is the cheapest cost avoider or cheapest risk taker, whereas all other risks should be borne by the customer and consequently not be part of the equilibrium price.
Information asymmetries can exist with regard to the possible reasons for, likelihood of and the extent and avoidance costs of a particular damage, as well as to the optimal contractual risk allocation. Contracts are concluded in spite of informational deficits due to the inability of consumers to process the information contained in the contract terms. Behavioural economics added further explanations to the theory of standard contracts. It argued that information asymmetry might be abused by traders taking advantage of consumers being subject to certain biases and suggested that consumers to proposed contracts undervalue adverse events. Consumers will typically grasp only a limited number of contract attributes and the majority focuses on the same attributes. This gives users of standard terms the chance to opportunistically introduce ancillary terms on less salient attributes (Korobkin, 2003). Sellers may hide onerous terms in the part of contract terms that are not approved, and abuse the system of pre-approval (Gabaix and Laibson, 2003).

Recent empirical research (Ben-Shahar and White, 2004; Marotta-Wurgler, 2007) tested the effects of one-sided clauses. As mentioned above, Marotta-Wurgler tested software licence agreements and showed that licences revealed a bias in favour of the software company that drafted the contract relative to the default terms in contract law, that larger and younger firms offer more one-sided terms, but firms offered similar terms to both business buyers and consumers (Marotta-Wurgler, 2007). She found little evidence for the argument that firms in concentrated software markets or with market power impose one-sided terms on consumers relative to the terms offered by firms in less concentrated software markets or with low market shares (Marotta-Wurgler, 2008).

Leff suggested that standard contract terms could be evaluated ex ante by administrative agencies (Leff, 1970) instead of being invalidated ex post by courts. These alternative policy options could include a certificate for a “fair set” of standard terms, a grading scale for the fairness of standard terms, or encouraging the drafting of model standard forms as a result of negotiations between business and consumer interest groups (Becher, 2007). These model sets can be adjusted to the specific features of different business sectors. A welfare-enhancing model of standard terms might provide an efficient way of stimulating the inclusion of such terms in consumer contracts. The availability of options is not diminished, allowing consumers to opt for other terms if they feel confident with deviating from default and thereby increasing their welfare. Small- and medium-sized enterprises would arguably be ready to free ride on the drafting efforts of other parties and also adopt the model form, ensuring a fair set of terms throughout the business sector (Luth, 2008; Luth, 2010).

Regulating contract terms through black and grey clauses, a list of unfair
terms can provide guidelines/reference points to the judiciary as to which terms are onerous to the extent that a consumer would be harmed by agreeing to them. As this provides clarity to all parties, inclusion of such a list would provide legal and economic certainty, reduce costs and increase welfare. A black list should include terms that are to the outright detriment of consumers, whereas grey-listed terms could in exceptional circumstances be agreed upon by both parties. Hence, a grey list deserves to be treated with caution. As a professional drafted the term, he is most likely to understand and to comment upon the admissibility of this particular term in the contract and the extraordinary situation that gave rise to this term. The burden of proof should therefore lie with the professional. A grey list does not diminish the availability of options, but it hinders the inclusion of certain terms.

However, the essentials of the contract, namely price and the main subject matter, as well as individually negotiated terms, are by definition salient to the consumer, and as such part of the consumer’s decision-making process. With respect to these product attributes, no information asymmetry exists between the consumer and the seller. The consumer would not enter into the transaction if these terms were disadvantageous. In the absence of misrepresentation and of market failure, the consumer is able to base her choice on available information. Some contract terms could very well be knowingly and willingly accepted by the consumer in negotiations even if the terms grant a less favourable position to the consumer than default terms when this is balanced by a decrease in price. For example, a shorter warranty period could be agreed upon in exchange for a lower price.

What behavioural economics adds to this view is that individuals suffer from several biases and heuristics when assessing risks. Consumers might willingly waive a certain right for a price premium, whereas the company with its expertise and available data knows that the waived term is likely to be more beneficial to the consumer than she expects. Black and grey lists as well as the fairness test can only bar the most onerous terms from being drafted into consumer contracts. A term that is not particularly onerous can be still be welfare decreasing for the majority of consumers. Furthermore, not all standard terms that allocate risks are covered in black and grey lists, nor are they easily assessed using the fairness test. Whether these cognitive errors in decision-making warrant further mandatory provision of terms, at the same time reducing consumers’ options, remains an open question until further evidence is found. Other policy options could be targeted at more efficient ways of dealing with consumer biases.
5. DISTRIBUTIONAL EFFECTS OF CONSUMER PROTECTION

The justification for mandatory rules has often been based on the belief that consumers are faced with disadvantages in the marketplace and that their unequal position can be ameliorated by different forms of regulation. In the legal literature, mandatory rules of consumer protection are justified by values such as distributive justice or fairness. The legislative reaction to such situations of adhesion has often been to award consumer rights through regulation, which aims at redistribution of power or resources (Kronman, 1983). The so-called power distribution or weakness argument contends that it is necessary to protect weak consumers in order to reinforce their bargaining position. The inequality of bargaining power between market parties can be remedied by redistribution through legal rules. This regulatory approach holds that the legislator can regulate the environment by means of mandatory rules to redistribute costs between the contracting parties and to restore equality between them (Rekaiti and Van den Bergh, 2000). The economics literature is critical of legal rules and institutions of consumer protection that follow a redistributive approach. It has been proved that contract law is unfit to accommodate redistributive goals (Kaplow and Shavell, 2002; Craswell, 1991; G. Wagner, 2005).

Distributive justice concerns the redistribution of power and resources on the basis of what is just rather than what is economically efficient. Its object is to shift wealth from one group to another by altering the terms under which individuals are allowed to contract in order to achieve a fair division of wealth among the members of society. The inequality of bargaining power between traders and consumers has been used to justify distributive measures, for example in the judicial control of standard contract terms. However, such measures disregard the fact that consumers do not form a homogeneous entity and thus such measures will have different distributional effects on different consumers, benefiting some and making others worse off. Therefore, legislators should be cautious about imposing measures without taking account of their distributive effects and decide to whom and from whom distribution should take place. Such measures may not improve the position of consumers and prove ineffective or even perverse as a result of passing on the costs of protection to consumers as well as considering the costs of administration and enforcement. Craswell shows when efficiency and distributional concerns may converge depending on how consumers value certain legal rules (Craswell, 1991; Cartwright, 2006). It has often been argued that distributive effects can be better achieved by the tax system than detailed regulation of individual transactions (Kronman, 1983).
Consumer protection is not a zero-sum game; it has its price. Mandatory rules implementing consumer rights generate additional costs for business that will likely be passed on to consumers. This cost increase will have to be balanced against the increase in the demand and supply of goods and services in order to prove that new rules are indeed necessary. The costs of a market failure have to be balanced with the costs of intervention and government failure and the impact of that remedy on the behaviour of affected entities should be estimated. These are the costs of legislation, enforcement and compliance, as well as the potential indirect effects of intervention on consumer and business behaviour. For example, competition might be reduced as a result of decreasing the number of low-quality and cheap products or services on the market.

Furthermore, the distributional impact of the costs and benefits among the different groups has to be considered. Intervention has its subsequent costs for governments and the implementation of new rules create compliance costs for business but also raise prices for consumers. To the extent that demand elasticity allows price increases business will pass on the costs of compliance, i.e. increased protection to consumers. This means that consumers pay for their own protection. For example, an information disclosure imposed by the state to reduce search costs has a different effect on different consumers. Such an intervention would raise firms’ average costs and accordingly leads to higher consumer prices. While this would reduce search costs for consumers who actively shop around, passive consumers would have to bear the increased costs without extra gains. The intervention is optimal only where the gain to active consumers (reduced search costs minus the increased price) outweighs the losses to passive consumers and the administration of the law (Craswell, 1991; Schwartz and Wilde, 1979).

Economics is concerned about the total welfare of both sellers and buyers without distinguishing between benefits to sellers or buyers. Efficiency and distributional concerns might coincide when all buyers value the legal rule identically, but when different buyers value the rule differently, then legal rules have different distributional effects on different subgroups of consumers. Craswell shows that the extent to which sellers are able to pass on costs or benefits to consumers affects the distributional goals of legal rules. The relevant question he poses is: when a mandatory rule has to be imposed, on what basis should such a legal rule be selected. Craswell argues that the distributional approach will coincide with the efficiency approach. As sellers pass on the costs of a new rule to consumers, consumers will benefit when their direct benefits exceed the costs of the rule to the sellers. The crucial question is how much of their costs sellers can pass on to consumers (Craswell, 1991).

The pass-on rate depends on the market structure, the elasticity of demand and on the fact that heterogeneous buyers value a certain legal rule differently.
When consumers are heterogeneous, the willingness to pay for a higher priced product or service on the part of marginal and infra-marginal consumers is decisive. Marginal consumers will stop buying the product or service when price increases and therefore they determine how high the price of the product or service will be.

Those consumers who gain from a legal rule can compensate those who do not or even be harmed by the higher prices. Craswell concludes that when sellers can pass on much of their costs arising from a legal rule, this indicates that consumers value the rule and benefit from the rule. When sellers cannot pass on much of their costs, then consumers found the rule less attractive. When consumers are homogeneous, then a comparison of the costs and benefits of the rule to sellers and consumers suffices to establish whether consumers benefit from the rule. When consumers are heterogeneous then the redistribution among consumers who benefit and those who lose has to be examined. But even in this case it is the preferences of different consumer groups which are decisive and not the ability of sellers to pass on their costs (Craswell, 1991).

Mackaay argues that public legal rules should substitute private rules where that option leads to costs savings. He puts forward the cost minimization formula developed by Wittman (Mackaay, 2009). Wittman argues that the role of contract law is to minimize the costs of the parties and of the courts writing contracts and the costs of inefficient behaviour arising from poorly written or incomplete contracts (Wittman, 2006). In other words, law and economics asks whether regulation has a cost advantage over parties’ self-protection. Regulation often aims to restrain opportunism, but pointing to this opportunism might suffice as well instead of direct regulatory measures (Gomez and Gauza, 2011).

Actually, EU consumer law can illustrate the distributional effects of consumer law and their relevance when policy decisions are made without taking account of the costs of rule formulation, of compliance, enforcement and indirect effects on other market behaviours at Member State level. Such an example is the costs of EU directives as regulatory means. Directives induce further costs of implementation at Member State level and require national courts to interpret and enforce the rules (Unberath and Johnston, 2007). While they might be cost-effective at EU level, they do generate substantial costs of implementation and enforcement at Member State level. Two examples follow to illustrate this.

In Club-Tour the European Court of Justice (ECJ) decided on the interpretation of package in Article 2(1) of the Directive on package travel upon

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the broadest possible protection of the consumer. The interpretation of “package” so as to include holidays organized by travel agencies at the request and according to the specifications of a consumer or a defined group of consumers generates costs for travel agencies, which have to take out insurance to cover the risk of insolvency under Article 7 of the Directive. Commentators have argued that as a consequence of this provision numerous small travel agencies might not have the appropriate degree of creditworthiness for such insurance or will simply pass those costs onto consumers. In EasyCar the ECJ was asked by the UK High Court whether Article 3 (2) of the Directive on distance contracts applied to car hire services. Advocate General (AG) Stix-Hackl argued that such services operate with reservation as a precondition and thus would be unreasonably affected by the requirements of the Directive and would generate opportunity costs. The right of cancellation generates extra costs that ultimately the consumer has to bear (Unberath and Johnston, 2007).

6. CONSUMER LAW ENFORCEMENT

An efficient law enforcement system depends on the optimal allocation of enforcement powers, the choice of enforcement tools and sanctions and the timing of intervention. The law and economics literature of law enforcement provides a number of economic criteria for the allocation of enforcement powers between private and public enforcement. These criteria include access to information about law infringements and the need to achieve an optimal level of enforcement, excluding both over and under-enforcement (Shavell, 1993; Polinsky and Shavell, 2000). The optimal level of enforcement depends on the likelihood of private or public agents initiating proceedings and the expected sanctions. The match or deviation of social and private interests in enforcement is decisive. Whether private incentives to sue coincide with the social interest to enforce the law depends on the private cost-benefit assessment of law enforcement. The likelihood of private or public agents initiating proceedings depends on and is determined by a set of incentives created by the expected financial award, the deterrent effect and the retributive motive the expected sanctions provide (Shavell, 1993). Rational apathy prevails when private incentives are insufficient to detect and litigate cases, i.e. where the expected private gains are lower than the costs of enforcement. Moreover, when individuals leave the enforcement to other

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15 See Opinion, paras 59–68 of EasyCar (UK) Ltd.
victims, the problem of “free-riding” occurs. Both rational apathy and free-riding leads to under-enforcement. The same happens when public enforcers are unaware of infringements, have limited resources or are subject to other types of regulatory failure, such as capture by private interest groups, lengthy administrative procedures, confirmation bias that affects public enforcers, hindsight bias or path-dependency of public enforcers and the desire to progress in career terms (Wils, 2004). When private parties excessively engage in a “race to damage” (Becker and Stigler, 1974), the problem of over-enforcement arises.

The availability of information concerning law infringements and the identity and location of the wrongdoer are key to consumers in order to initiate proceedings. Consumers are often unaware of law infringements before actual harm has occurred. Consumer problems are complex, diverse and diffuse both over consumer groups and over time. The adverse effects of consumer offences might be realized later in time. They are moreover unpublicized and therefore difficult to detect and address. Public agencies with investigative powers can better detect violations of, for example, false advertising or unfair contract terms. Consumers might not be informed of their rights of redress, especially when contract terms in the contracts they signed deviate from mandatory consumer protection laws.

Another concern is that private consumer interests often do not coincide with public interests. Therefore consumers lack incentives to litigate, which in turn results in less enforcement. In other words, private enforcement carries considerable risk of under-deterrence. Private enforcement is thus more advantageous when private individuals possess information about consumer law violations and their private interests coincide with the socially optimal enforcement level (Veljanovski, 1981; Polinsky and Shavell, 2000). When private consumer interests do not coincide with social interests, private parties will have no incentive to bear the costs of law enforcement. When individual consumers face substantial costs that are disproportionate to the amount of their complaint, they will decline to seek redress and resolve disputes. Especially in cases where damage is widespread and individual losses are low, rational apathy prevails among injured individuals, who will not sue. Private consumers are much more influenced by costs and benefits than public bodies enforcing the law. Private parties have to bear the costs of accessing information in order to discover the infringement, litigation costs, consisting of the lawyer’s fees and perhaps expert witnesses (Van den Bergh and Visscher, 2008).

The legislative choice between public authorities or private organizations and private individual consumers as enforcers depends on factors such as costs, delay, access and the quality and quantity of dispute resolutions. Public authorities will be more efficient in cases where they can realize economies of
scale, specializing in investigating and prosecuting claims and where they can impose penalties and other deterrent measures that are unavailable to private individuals in civil proceedings (Trebilcock, 2003).

Whenever private individuals or private organizations enforce the law by filing law suits and civil courts adjudicate on the matter, law enforcement will be costly and time consuming, involving as it does complicated legal, economic and practical matters. Therefore, there seem to be good arguments in consumer law for public authorities to set market regulatory standards and to issue pecuniary fines for violations of standards (Schaefer, 2000). Public enforcement seems to be a more efficient solution not only because of the various limitations on consumers’ capacity and motivation to take action, but also because of the limited competence and in certain jurisdictions the limited readiness of the civil courts to rule on consumer law questions (Scott and Black, 2000; Cafaggi and Micklitz, 2008).

Public enforcement seems justified because consumers often face difficulties in recognizing market failures such as inferior quality in markets and in detecting law infringements. Consumers are often unaware of infringements until actual harm has occurred. Public agencies armed with sufficient investigative powers can remedy this shortcoming. The comparative advantage of public enforcement is undebated with regard to quality and safety regulation. Besides incomplete information of individual consumers, the divergence between private and social benefits in prosecuting law violations pleads for public enforcement. The proper functioning of markets is valuable for individual consumers as well as for society. Moreover, the losses suffered by individual consumers are smaller than the losses of society as a result of quality deterioration and adverse selection. Consumers have insufficient incentives to enforce consumer law because their personal financial reward is small compared to the costs of enforcement and they will benefit only marginally from the deterrent effect of enforcing consumer rules against wrongdoers. Consumers discover harm when it has already taken place and thus are not interested in avoiding future harm. Moreover, they have insufficient retributive motives. These factors result in under-enforcement (Van den Bergh, 2007). In sum, private enforcement of consumer law is inefficient at achieving deterrence because of lack of information and the risk of under-enforcement.

Furthermore, courts decide disputes on a case-by-case basis and they are not capable of building long-term policy lines. Individual cases cannot address systematic consumer problems that would have a meaningful impact on corporate policy and behaviour and that would be capable of addressing collective interests. Regulatory agencies rather than civil courts have the expertise and the specialization to deal better and in a more cost-efficient way with market regulatory issues. Furthermore, they are also in a better position to impose behavioural standards and sanctions (Howells and James, 2003).
Duggan discusses the role of costs in litigation and the benefits of a civil justice system from a law and economics perspective (Duggan, 2003). Adjudication has social benefits in terms of lowering the social costs of disputes by facilitating well-organized dispute resolution instead of costly disorder and in terms of limiting the number of disputes by guiding future behaviour through judge-made law. It operates as a deterrent through encouraging private individuals to take cost-effective preventive measures and by avoiding liability in future cases. The main objective is to achieve an optimal amount of litigation, i.e. an “equilibrium in the market for consumer justice”. There are factors on both the supply and demand side that discourage litigation. Direct legal costs, such as court fees and lawyers’ fees, have a fixed and a variable component. The high fixed costs inherent in civil litigation discriminate in favour of large claims and make small claims uneconomical. Indirect costs, such as information, opportunity and emotional costs, favour repeat players who can achieve economies of scale and who can spread costs over a large number of claims. These insights show that the conventional civil justice system is biased against consumer litigation, which often involves small value claims and one-shotters. Solutions for consumers could be litigation methods that can either spread or avoid litigation and other associated costs (Duggan, 2003).

Most consumer problems are of an individual nature. A large part of consumer law is private law and as such was intended to assist consumers to make use of their protected rights. On this line of argument, consumers themselves are responsible for initiating actions, for solving their dispute with business and for seeking redress. The assumption that consumers know their rights and are sufficiently motivated to enforce them implies that private enforcement of consumer rights is a direct consequence of the economic self-interest that in the case of business wrongdoing forces them to take action. Private individual enforcement is, therefore, to be preferred because it overcomes government failures of enforcement such as lack of resources and capture. Individuals also have the best knowledge of the harm suffered and they have the incentive and motivation to take action (Scott and Black, 2000).

The central issues in consumer law are the efficient balance between private and public enforcement, individual redress schemes, collective actions and, besides injunctions, the introduction of damages actions. The effectiveness of the institutional framework has a direct impact on the efficiency of the redress system. With regard to entrusting enforcement to public bodies or to private individuals or private organizations, the question is not so much an “either-or” but rather what is the most effective allocation of enforcement between public law and private law techniques and how to achieve an optimal combination between these two techniques so that they can effectively complement each other.
6.1 Public Enforcement of Consumer Law

With regard to the enforcement of consumer law, the question is which parts of consumer law are fit to be enforced by a public agency. In the law and economics literature, information asymmetries form the most valid economic reasons to intervene in markets and serve as a rationale for regulation in order to protect consumers. Transaction costs, information deficits and cognitive dissonances are accepted arguments to justify intervention in otherwise unrestricted market processes. Information on prices, quality, the nature and consequences of consumer purchasing decisions, as well as the way this information is provided and processed by consumers form the core issues. In law and economics, consumer protection is regarded merely as a subsidiary solution to market failures in case the private law system of individual enforcement fails and competition control is exhausted (Ramsay, 1985). Insights from neoclassical economics on information asymmetry, adverse selection, moral hazard, transaction costs, as well as recent findings from behavioural economics about systematic cognitive errors in consumers’ decision-making have relevant implications for the design of new regulatory frameworks and setting priorities for regulatory agencies.

Accordingly, public enforcement is justified when there is a serious risk of adverse selection in the marketplace, when consumers face difficulties in discovering infringements and when the size of the total harm significantly exceeds the individual damage suffered (Van den Bergh, 2007). Information deficit on the consumer side is usually connected with consumers’ uncertainty about the quality of products, which cannot be assessed at the moment of purchase. The markets in experience and credence goods form priorities for intervention. Experience goods can be evaluated upon consumption, whereas the quality of credence goods will not be clear even after buying the product. When consumers cannot assess the quality of a certain product, other product characteristics like price will dominate the decision-making process. Consumers’ uncertainty about the quality of experience or credence goods creates a danger of quality deterioration and leads to adverse selection or moral hazard (Akerlof, 1970).

Shavell has presented a framework for determining which parts of the law should be enforced by private parties and left to civil liability rules and which should be enforced by public agents and thus regulation. Four determinants are: differences in knowledge about risky activities as between private parties and regulatory authorities, the possibility that parties would not be able to pay fully for the harm done (judgment-proof problem), the chance that they would not face suit for harm done and administrative costs (Shavell, 1984).

On the basis of these criteria, a selection can be made of those areas of consumer law where public enforcement is more efficient than private
enforcement. “Signing without reading” in standard contract terms (De Geest, 2002b) involves the risk of adverse selection. Financial services such as consumer credit are typical credence goods, where uninformed consumers face informed sellers. Consumers cannot, even after purchase, evaluate the quality of the goods and services and thus cannot distinguish between poor and good quality goods. The risk of adverse selection is high. Unfair trade practices such as misleading or aggressive advertising form an area where consumers individually lack the incentives to complain and take action and thus rational apathy prevails. In these cases, consumers are often not aware of the harm. On the contrary, with regard to package travel, timesharing or price indications, consumers have better information about legal violations and eventual harm. Rational apathy about complaining and taking action also seems less of a problem. Doorstep selling and distance contracts are parts of consumer law where cooling-off periods apply and thus consumers have enough time to avail themselves of the necessary information to conclude the deal or refrain from it.

The enforcement of consumer law substantially differs across jurisdictions. The Netherlands, for example, has mainly relied on private enforcement, while the Nordic countries have a strong public enforcement regime. In the EU, Regulation 2006/2004 intervened in national enforcement systems by imposing conditions under which national authorities responsible for enforcing consumer rules must cooperate with each other. Cooperation between public authorities is regarded as necessary in order to protect consumers’ collective economic interests cross-border in the internal market. The Regulation requires a public enforcement mechanism for a set of 15 directives that mostly concern private law rules. The Regulation imposed public enforcement for the consumer acquis; however it does not regulate sanctions. This approach considerably disrupts the Member States’ present enforcement schemes. A prime example of this distortion is the establishment of the Dutch Consumer Authority and creation of a dual system of public and private enforcement based on a subsidiarity principle.

While according to recital 11 the aim of the Regulation was to coordinate at Community level the enforcement activities of the Member States in respect of intra-Community infringements and to contribute to raising the standard and consistency of enforcement, it has clearly had a relevant impact on the domestic institutional structure of consumer protection in the Member States.16 The Commission has acknowledged the essential role consumer

16 Regulation 2006/2004 on consumer protection cooperation has set up an EU-wide network of national enforcement authorities and enables them to take coordinated action for the enforcement of the laws that protect consumers’ interests and to ensure compliance with those laws. On the basis of Article 4, each Member State was obliged
organizations play in the enforcement of consumer law, but it has unfortunately not involved them in the process of achieving effective and uniform enforcement EU wide. This is evidenced in the pure public enforcement scope of the Regulation on consumer protection cooperation. The sharp tilting of the institutional framework towards centralized public authorities is also mirrored in the Commission Report on Article 4 (3) of Directive 98/27/EC on injunctions concerning the entities qualified to bring an action under Article 2 of this Directive (Van den Bergh, 2007; Cseres, 2007).

6.2 Private Enforcement of Consumer Law

There are two significant ways in which private enforcement can take place: alternative dispute resolution (ADR) and collective actions. The options for individual redress schemes allowing individuals to resolve disputes and obtain redress at a cost and burden proportionate to the amount of their claim range from informal attempts to resolve complaints directly with the company, to alternative dispute resolution services and formal legal action in small claims courts. Out-of-court procedures and especially ADR seem to be best suited to individual consumer disputes. The advantages of such schemes include informality, the efficiency of solving disputes in a speedy way, low costs, confidentiality, simplicity and flexibility. These factors are also relevant for business. Swift, low-cost and informal solutions are also meaningful for business as they create a better opportunity for settlement and can in turn increase business compliance with the agreed solutions and thus improve satisfaction with the outcome or manner in which the dispute is resolved. Certainty and trust in these schemes is equally important for the supply and demand side (Cseres, 2007).

The disadvantages of these alternative schemes are equally well-known: the willingness of business to participate, the non-enforceable legal nature of decisions by some ADR bodies, the lack of independence and competence of the ADR bodies. There are generally accepted principles that address the reduction of these disadvantages such as accessibility, independence, fairness, accountability, effectiveness and efficiency (Stuyck et al., 2007).

to designate the competent authorities and a single liaison office responsible for the application of the Regulation. On the basis of Article 5, the Member States had to communicate to the Commission and the other Member States the identities of the competent authorities, of other public authorities and bodies having a legitimate interest in the cessation or prohibition of intra-Community infringements, and of the single liaison office.

See Article 3c on the definition of a competent authority: “competent authority” means any public authority established either at national, regional or local level with specific responsibilities to enforce the laws that protect consumers’ interests”.

OJ C 39 of 16.02.
Individual consumer action has numerous limitations and is not an optimal solution in all cases. When individual consumers have suffered similar harm and when the economic loss suffered by each consumer is small and widespread, individual consumers often do not have the incentives or the capacity to act individually. In these cases some kind of collective action can be more efficient. Collective actions can provide solutions to both the individual incentive problem and the public policy concern. Collective actions can consolidate widely dispersed small-scale claims. They form avenues of litigation that are less disruptive for the market than individual litigation. They are cost-spreading solutions that can overcome the reluctance of consumers to bring complaints. Collective actions can solve the incentive problem of many individual consumers in cases where the harm caused by a violation of the law is vast, but the harm caused to individuals is so fragmented that they refrain from litigating. Consolidating these claims is therefore essential for consumers who have suffered harm. Collective actions can reduce litigation costs, enlarge litigation possibilities and provide optimal representation of consumers in court proceedings. Recent Eurobarometer surveys of the European Union have indicated that citizens would be more willing to defend their rights before a court if they could join with other consumers who were complaining about the same thing.  

Bundling these fragmented individual claims can considerably enhance law enforcement as collective actions have a higher probability of preventing future harm to consumers and thus have a stronger deterrent effect than individual claims. Moreover, collective action carries efficiency benefits both for business and the judicial system by providing a less disruptive and fragmented way of litigation and increasing the merits of the claims brought before the courts. This saves costs, resources and time for both business and the courts (Schaefer, 2000).

Nevertheless, the adverse effects of collective actions are also well-known. Collective actions can create incentives to bring meritless claims, as examples in the US show. Moreover, collective actions do not always serve the goals they have been created for. Consumers might be “hijacked” by their lawyers, who claim excessive class action attorney fee awards. Such contingency fees represent a significant source of consumer harm, as they diminish the total compensation available to injured consumers. To the extent that such fees do not accurately reflect the amount of work performed by the attorney, or the value of the settlement to the class, they may also create distorted incentives,
thereby promoting excessive litigation that is not only contrary to the interests of the class, but unnecessarily raises the cost of goods and services to consumers generally. Especially settlements involving coupon or other non-pecuniary compensation raise conflict-of-interest concerns. The interests of private class attorneys and defendants are aligned to the detriment of the class members; injured plaintiffs may be offered insufficient redress while defendants obtain broad release from liability and class counsel receive generous fees (OECD, 2006).

Overall, while collective actions should be carefully and efficiently designed, in consumer law enforcement it has clear advantages in terms of expertise, investigative powers and sanctions. In the EU, Regulation 2006/2004 on consumer protection cooperation has already created a framework for the Member States’ competent public authorities. The Regulation sets up an EU-wide network of national enforcement authorities and enables them to take coordinated action for the enforcement of the laws that protect consumers’ interests and to ensure compliance with those laws. Within this framework, the role and cooperation between the various public authorities should be explored. Learning effects among these agencies are important. Learning effects between public and private enforcement are equally valuable.

Further determinants of the institutional design are choice of sanctions (monetary fines, damages, injunctions, and the time of intervention – ex ante control and monitoring, ex post enforcement).

6.3 Choice of Remedies and Sanctions

The objectives of consumer law enforcement aim at effectively influencing and imposing a meaningful impact on corporate policy and behaviour. The objectives refer to prevention, restitution, and punishment. Preventive measures must be designed so that sellers’ rights are not unfairly restricted and consumers’ rights and interests are protected, while least interfering with the competitive process. Punishment applies in cases involving only the most abusive practices. Restitution offers the promise of developing remedies that are equitable to both buyers and sellers (Cohen, 1975). The primary objectives are deterrence and prevention, while compensation of victims also plays a role. The law and economics literature assesses when deterrence is optimal depending on the form of sanction, adverse publicity, costs of enforcement. Optimal deterrence is achieved when the harm caused by law infringements is outweighed by the magnitude of the sanctions. Therefore the expected sanction has to exceed the utility of the opportunistic behaviour earned through infringing the law (Landes, 1983; Garoupa, 1997).

Remedies and sanctions for consumer law infringements vary across jurisdictions from administrative fines, to civil law and criminal law sanctions. In
most European jurisdictions, the present set of remedies for consumer offences is limited to declaratory remedies such as formal and informal warning, and injunctions. Sanctions are mainly in the form of administrative fines and criminal sanctions such as fines and imprisonment. Monetary remedies in the form of damages claims can provide consumers with compensation for damages suffered as a consequence of “anti-consumer” practices (Van den Bergh, 2007).

The efficiency of remedies and sanctions is discussed in the economic analysis of law enforcement by comparing the costs and benefits of law infringements for traders. When fines are too low, business will consider whether the economic gains still outweigh the fine and other associated costs (Becker, 1968). The deterrent effect of fines is further weakened because business can shift the burden in the form of increased prices to the public. The fine will be regarded as a licence fee to infringe the law (Cranston, 1984). The deterrence of sanctions depends on the formal sanction, adverse publicity, costs of lawyers and the amount and quality of agency monitoring. Social costs of law infringements should be lower than enforcement costs, which includes both administrative and error costs. Enforcement costs are ultimately paid by taxpayers and traders can also pass on their costs of lawyers or management to consumers (Van den Bergh, 2007).

The sanctions should outweigh the harm caused by violating consumer rules and should be multiplied by the probability of detection and of punishment for the violations (Van den Bergh, 2007). However, administrative sanctions in the form of corporate fines have limited impact on corporate behaviour. While in competition law there are recent economic studies that show that fines based on a percentage of sales concerned are substantially less than the estimated benefits related to the average infringement (Connor and Bolotova, 2006; Wils, 2005), the effectiveness of fines has not been extensively examined in consumer law. It can, however, be reasonably argued that the low level of fines for consumer law violations are often seen as a fee to stay in the market. In both areas a relevant drawback of these sanctions is that they affect the corporation and not the private individuals, which can be both higher and lower management, who decide on the undertakings’ business strategy, including possible anti-competitive and anti-consumer acts. There is an extensive body of corporate governance literature, based on principal-agent problems relating to asymmetric information and imperfect monitoring, which points out that managerial incentives are often difficult to reconcile with corporate profit maximization objectives (Cseres et al., 2006).

When a consumer offence causes economic losses, some kind of action for claiming damages seems justified, as well as an efficient way to remedy harmed consumers. The difficulties of such damages actions in the context of competition law have been widely discussed (Renda et al., 2007). Some of
those barriers of litigation equally apply in the consumer law context. While issues such as passing on and standing for consumers seem of little relevance in the case of consumer offences, still access to evidence, detection and investigation, the costs of identifying injured parties and estimating damages pose serious limitations on individuals’ readiness to bring such claims. Introducing damages claims in the consumer law context faces the same hurdle as in competition law: compensating individuals stands in contrast to the lack of legal and economic incentives for consumers. A solution seems to lie in creating some kind of collective actions that can be a cost-efficient solution when consumer offences have caused widespread but small economic harm to individual consumers and the individual motivation to take action is low (Schaefer, 2000; Cseres, 2007).

There are two other concerns related to damages calculation and cross-border enforcement. With regard to damages, the question of actual damages calculation arises in relation to consumer offences such as health and safety issues and when the damage has not yet materialized, for example when dangerous products are detected but no one has suffered physical or economic harm. Moreover, what is the actual damage in these cases or where there is “moral damage” to consumers? Damages claims are even further complicated when the group of consumers who suffered harm includes consumers outside the territory of one Member State (Cafaggi and Micklitz, 2008).

Imposing criminal sanctions has important economic, social and political implications. It requires special procedural rules, enhanced and strong investigative powers, courts that take an active role, as well as high standards of proof as the offence will then have to be proven beyond reasonable doubt. It also requires the readiness and willingness of courts to impose strict criminal liability even when the punishment is imprisonment. The application of criminal sanctions requires more complex, more careful and most probably more time-consuming procedures (Cseres et al., 2006).

Criminal law sanctions in the case of, for example, product quality and safety prove to be powerful enforcement tools. In certain cases, civil law redress is unavailable as the damage has not yet materialized. Problems, however, seem to exist with regard to detection and prosecution (Cranston, 1984). Detection of violation of competition and consumer rules is a significant concern (Bryant and Eckard, 1991). Consumer offences are often complex, diffused over time and unpublicized, which makes detection highly complicated and sometimes even impossible before a certain period of time has elapsed.

Cartwright defends the use of criminal sanctions in consumer protection as an effective tool to discipline business behaviour. He argues that instead of decriminalization, criminal sanctions should retain their central role in the protection of consumers. He rather calls for a reassessment of the ways in
which regulatory crime operates. He further points out that while health and safety measures are intended to protect consumers’ physical safety, they can raise potential barriers of trade. He suggests reassessing the role of criminal sanctions against this background (Cartwright, 2006). Similar conclusions have been drawn by Parry, who has argued that in the area of product quality the interplay between civil law redress and criminal law sanctions when both physical and economic harm has been caused proves them to be valuable tools (Parry, 2002). Van den Bergh argues that criminal sanctions might be inappropriate for public enforcers. Enforcement agencies often lack the resources to comply with the complex, cost and time-consuming procedures and the probability of errors is also high. Courts are also often reluctant to impose harsh punishments or the sanctions remain low and thus ineffective to deter (Van den Bergh, 2007). Criminal sanctions should, therefore, be reserved for repeated law violations and gross moral conduct (Ogus et al., 2006).

Beyond criminal sanctions such as jail sentences for top executives, the role of the media is essential in consumer cases. In fact criminal prosecutions carry a powerful deterrent effect through the publicity they receive. The power of adverse publicity, for example by setting up black lists, has earned valuable experience in consumer law enforcement.

Other means to achieve effective enforcement can be freezing business assets or requiring the creation of compliance programmes. In some jurisdictions, courts can issue provisional remedies before a case is decided in order to maintain the status quo pending the outcome of the case. One important type of provisional remedy is a temporary order that “freezes” a defendant’s assets to ensure that there will be funds available at the conclusion of the case to satisfy the judgment. An asset freeze places a temporary hold on the assets of the defendant, pending the outcome of the case. This protective tool, where permitted, greatly increases the likelihood of collecting on any money judgment that is ultimately issued for return to consumers (OECD, 2005).

6.4 Time of Intervention

The institutional divide between ex ante control and monitoring and ex post control of law infringements has traditionally had implications with regard to time. Administrative control over product safety and quality has been an ex ante and judicial enforcement has been an ex post device when consumers suffered damages as a result of marketing certain products. Allocation was determined by the availability of information. Ex ante control is justified when firms have limited knowledge whether their practices will violate the law. If the information became known only after violation of the law, then judicial enforcement was applied. In consumer law there has been a strong tradition of ex ante monitoring, especially in the field of health and safety standards. The
regulatory modes are, however, changing. There is a move towards iterative and *ex post* control in the monitoring of product-related risks and administrative control involves rule-making as well as operating through standard-setting market-based and responsive regulation. Regulators and firms cooperate in setting quality and safety standards and private bodies participate through control strategies of a self-regulatory nature. In judicial enforcement, injunctions serve as a way of preventing firms from selling unsafe products or services and to force them to remove such products and services from the market (Cafaggi and Micklitz, 2008).

7. THE EU MODEL OF CONSUMER PROTECTION

European consumer law comprises mandatory rules that intervene both with the freedom of contract of market actors as well as with the national legislation of the Member States. The European model of consumer protection can best be captured along two dimensions: on the one hand, by examining the balance European consumer law establishes between default and mandatory rules. Such a balance is a key aspect of a private law system that tries to establish an institutional framework for an efficient market. On the other hand, by examining the intervention it imposes on the laws of Member States.

EU consumer law has been characterized as being instrumental and protective. It was instrumental as its primary goal was to complete the internal market and this has significantly influenced its protective function, shifting the European normative concept closer to free market mechanisms than social policy concepts. Micklitz argues that EU consumer law is market bound; in national law, it is social policy bound (Micklitz, 2002). The development of an autonomous consumer policy in the Community took place parallel to a strong integration process based on the four freedoms and competition law and it compelled consumer policy to take a secondary role in overall EU policy making (Stuyck, 2000). Consumer protection departed from the premise that when certain framework conditions, such as an open market with effective competition, were guaranteed, consumer welfare and living standards would rise as a result of market mechanisms. Article 4 of the Treaty on the Functioning of the European Union (TFEU) (former Article 3 EC) made it clear that the goals of the Union as laid down in Article 3 of the Treaty on European Union (TEU) could be achieved by measures oriented towards competition and the four fundamental freedoms (Reich, 2003). The rationale behind European consumer protection has always been the creation of a “level playing field” and not consumer protection as an end in itself. Community consumer protection was drafted on the basis of the perception that businesses needed a common set of rules in order to take advantage of the internal market.
Consumers were regarded as the passive beneficiaries of free trade and as the incidental beneficiaries of the harmonization of laws (Weatherhill, 1996). In other words, EU consumer protection was indirectly addressing the harmonization of consumer protection rules. This could be evidenced by the fact that former Article 95 EC (now Article 114 TFEU) has been the main legal basis for adopting legislation in the field of consumer protection.20 Even though the Maastricht Treaty has created a specific legal basis for consumer protection and an EU competence independent of the internal market impetus that has been considerably enlarged in the Amsterdam Treaty, former Article 153 EC has hardly been used as a legal basis. Only one directive has been adopted on the basis of Article 153 EC.21 Other directives were still adopted on the basis of former Article 95 EC, although the Commission’s proposal was initially based on former Article 153 EC (Stuyck, 2000).22

Consequently, the EU model of consumer protection was based on the idea that consumers merely needed a minimum set of Community measures in order to be able to conduct cross-border transactions. This model corresponds to economics, which treats consumer protection as a subsidiary solution to correct market failures when the private law system of individual enforcement fails and competition law control is exhausted (Ramsay, 1985). Consumer protection plays a secondary role besides the primary framework composed of competition law and contract law (Mattei, 1999).

EU consumer protection is further characterized by a normative concept of a well-informed and confident consumer (Weatherhill, 2002) and by the adoption of information provisions instead of corrective legal measures. The European Court of Justice (ECJ) has reaffirmed this concept by developing a liberal consumer image, putting the emphasis on the consumer’s own responsibility and the beneficial working of market forces such as freedom of

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20 Consumer protection became an autonomous policy aim in 1987 with the adoption of the Single European Act. However, the Single Act of 1987 was concerned, first of all, with the progressive establishment of the internal market and thus consumer policy was seen as complementary to the market process. It complemented other regulatory tools aimed at establishing the internal market. Consumer protection legislation was from that moment onwards adopted on the basis of Article 95, which appointed new areas for minimum harmonization, such as health, safety, environmental protection and consumer protection.


22 Another reason for the infrequent use of former Article 153 EC has been that the Member States retain the main competence to legislate consumer protection and thus when the EU wants to adopt legislation unanimity is needed under former Article 153 EC. With 27 Member States the usefulness of Article 153 has significantly diminished (Mak, 2008).
contract and competition. This model is based on the idea that consumers should be able to make informed choices rather than government regulation defining that choice. Full and adequate information does not only protect consumers, but it is also a condition sine qua non for the functioning of competition and of the operation of the market. The legal framework of the internal market has to guarantee the free and unrestricted flow of information for consumers and suppliers in order to safeguard a sufficient level of market communication.\(^{23}\) The free flow of information is an essential element of EU consumer protection and it is one which takes precedence over other consumer protection considerations. It has developed into an information paradigm, which forms one of the main pillars of consumer legislation in the EU.

### 7.1 The Economic Function of EU Rules

The intervention EU consumer law imposes on the laws of Member States can be examined through the economic function of EU mandatory rules. The economic function of these rules is to address a number of specific market failures such as information problems and transactions costs in cross-border consumer contracts, the positive and negative welfare effects of harmonization and the diverging preference structures of various consumer groups.

The Commission has regularly identified the lack of consumer confidence in making cross-border purchases as the core problem EU consumer protection should address. According to the Commission, the source of consumers’ lack of confidence is to be found in the fragmentation of legal rules. This fragmentation is, on the one hand, the result of minimum harmonization and, on the other hand, the consequence of inconsistencies between EU directives.

However, the lack of consumer confidence as a market failure has been strongly criticized by the ECJ. The ECJ stated that the goal of EU intervention has to be precisely stated by explaining the actual problems consumers face in the internal market and the actual obstacles to the free movement principles as well as the distortions of competition. In *Germany v. Parliament and Council*, the ECJ explicitly said that “a measure adopted on the basis of Article 100a of the Treaty must genuinely have as its object the improvement of the conditions for the establishment and functioning of the internal market. If a mere finding...

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\(^{23}\) This principle was recognized by the ECJ in Case C-362/88, *GB-INNO-BM v. Confédération du commerce luxembourgeois*, [1990] ECR I-667, by saying that “…under EU law concerning consumer protection the provision of information to the consumers is considered to be one of the principal requirements. Thus Article 28 cannot be interpreted as meaning that national legislation which denies the consumer access to certain kinds of information may be justified by mandatory requirements concerning consumer protection”.

of disparities between national rules and of the abstract risk of obstacles to the exercise of fundamental freedoms or of distortions of competition liable to result there from were sufficient to justify the choice of Article 100a as a legal basis, judicial review of compliance with the proper legal basis might be rendered nugatory.”

Moreover, in the “Tobacco Advertising” judgment, the ECJ annulled the Tobacco Advertising Directive as having been invalidly adopted under Article 114 TFEU (former Article 95 EC). Two years later in the “Tobacco Labelling” judgment when applying the same arguments it approved the adoption of the Tobacco Labelling Directive on the basis of Article 114 TFEU and it thereby reaffirmed its interpretation of Article 114 TFEU as a legal basis for measures of harmonization. The Court argued that the measures referred to under Article 114 TFEU “are intended to improve the conditions for the establishment and functioning of the internal market” and “must genuinely have that object, actually contributing to the elimination of obstacles to the free movement of goods or to the freedom to provide services, or to the removal of distortions of competition”. The ECJ further stated that “recourse to Article 95 EC as a legal basis is possible if the aim is to prevent the emergence of future obstacles to trade resulting from multifarious development of national laws, the emergence of such obstacles must be likely and the measure in question must be designed to prevent them”. Accordingly, when the Commission intervenes in the internal market through positive harmonization of consumer protection, it has to define consumer problems precisely by providing clear evidence of their nature and magnitude, explaining why they have arisen and identifying the incentives of the affected entities and their consequent behaviour. The Tobacco judgments are relevant milestones in the overall policy-making of the EU. They signalled a new approach that takes subsidiarity and proportionality seriously and narrowly defines the competencies of the Union institutions vis-à-vis the Member States. In fact the Court in these judgments made a strict cost-benefit analysis of the extensive

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30 Germany v. Parliament and Council, para. 84, cited in British American Tobacco, Case C-491/01, para. 60.
31 British American Tobacco, para. 61.
integration process and commended for safeguarding the competences for public health at local level (Tridimas and Tridimas, 2002).

7.2 The Principles of Subsidiarity and Proportionality

The intervention of consumer protection in the EU internal market has developed along the lines of negative and positive harmonization. Negative harmonization has taken shape through the ECJ’s case-law and positive harmonization through the Commission’s legislative work. This intervention has been governed by the principles of proportionality and subsidiarity as laid down in Article 5 TEU. Both principles call for an economic analysis and can be reformulated in economic terms. The subsidiarity principle is to guarantee efficient cooperation between the EU and its Member States. It obliges the European legislators and policy makers to apply a cost-benefit test when they choose between harmonization of laws by taking action at a central level or competition among different national laws at a decentralized level. Legislative actions on the EU level are to complement, rather than to replace, the efforts of national, regional or local authorities to defend consumers’ rights. Van den Bergh argues that subsidiarity can serve as an economic demarcation principle that distributes competences between the EU and the Member States and helps to decide on institutional arrangements (Van den Bergh, 1994, 1996, 1998).

The wording of Article 5 TEU invites an economic analysis, when it states that in order to justify the exercise of powers by European Community institutions “the scale or effects of the proposed action” must be taken into account. This formulation invites the consideration of scale economies and externalities, two economic arguments in favour of centralization. Article 5 TEU calls for trans- action costs minimization and sets a preference for decentralization as long as the benefits of competition between legal orders outweigh the costs (Van den Bergh, 1994, 1996, 1998).

The principle of subsidiarity and its inherent transaction cost minimization in Article 5 TEU require that the benefits of legal measures outweigh their costs (Schwintowski, 2001). For example, the debate on harmonization of private law neglects the fundamental question of whether the Union can harmonize private law. The answer is, in fact, that the Union does not have an independent constitutional basis for exercising its powers in the unification of private law. Union action in the area of private law is limited by the objective to achieve an internal market.

The proportionality principle acts in a similar way, requiring that measures are taken in the most cost-effective way, avoiding overregulation and unnecessary costs (Van den Bergh, 2002). The Union should intervene “only if and in so far” as centralization leads to better welfare effects (Van den Bergh, 1994, 1996, 1998). The proportionality principle serves as a demarcation line.
between the internal market impetus and consumer protection in cases concerning the free movement of goods. Consumer protection has been the most important ground for justifying a restriction of the free movement of goods under Article 34 TFEU and the free movement of services under Article 56 TFEU. According to Article 36 TFEU, mandatory requirements of general interest, such as consumer protection, can justify the violation of the free movement principle. The ECJ has developed this test in its judgment in *Cassis de Dijon*.32 Accordingly, even a rule which applies without distinction to domestic and foreign products alike may impede trade between Member States. Nevertheless, such a national provision may be exempted on the specific grounds of consumer interests. However, consumer protection measures have to be appropriate and proportionate in the light of the consumer protection pursued in order to be justified. The balancing by the Court is actually a comparison of the consumer interest served by market integration and the consumer interest pursued by a national rule at the expense of market integration (Weatherhill, 1996).

*Cassis de Dijon* further introduced the principle of mutual recognition, which encourages competition among legal systems and favours low levels of regulation through minimum harmonization norms and deregulation (Unberath and Johnston, 2007). In the case-law that builds on and extends *Cassis de Dijon*, the ECJ made it clear that it preferred deregulated markets offering a wider choice for consumers than regulatory protection in a national market insulated from external competition. The ECJ has found a number of national consumer laws or unfair competition rules that proved to be disproportionate or purely protectionist. In *Cassis de Dijon*, the ECJ introduced the country of origin principle33 and thus provided a legal basis for competition between legal systems. In *Keck and Mithouard*,34 this principle has been restricted with regard to marketing techniques (Van den Bergh, 1994).

In sum, as EU consumer law overrules national default and mandatory rules, the harmonization of consumer law has to be considered vis-à-vis the freedom of contract and the mandatory rules of the Member States. The welfare effects of consumer law harmonization cannot be assessed without the welfare effects of limiting party autonomy and freedom of contract in the national jurisdictions (Kirchner, 2001). The potential welfare effects of harmonization should be balanced with the potential negative effects of reduced freedom of contract (Kirchner, 2001).

33 The country of origin principle states that, where a product is manufactured or a service is performed in one country but sold in another, the applicable law is the law of the country where the product is manufactured or service is performed.
7.3 The Economics of Harmonization

As mentioned above, in EU law the harmonization process is governed by the principles of subsidiarity and proportionality. These principles entail a cost-benefit analysis of legislation and require transaction costs to be minimized. The economics of harmonization discusses the costs and benefits of legal diversity and harmonization. It addresses the optimal level of intervention by applying the economic theory of federalism as extended in the theory of regulatory competition.

The idea that decentralized decision-making may contribute to efficient policy choices in markets for legislation was first formulated by Tiebout in his classic article on the optimal provision of local public goods. Tiebout’s model has been extended to legal rules and institutions. The theory of regulatory competition applies the dynamic view of competition to sellers of laws and choice between legal orders, offering a number of criteria to judge whether centralization or decentralization is more successful in achieving the objectives of the proposed legislation (Van den Bergh, 1994, 1996, 2002). In this section, these criteria will be applied to the Commission’s harmonization proposals in order to analyze the probable costs and benefits of top-down rule-making.

Neoclassical economics offers a number of criteria for judging whether centralization or decentralization is more successful in achieving the objectives of the proposed action. Economic reasons in favour of centralization are: the danger of destructive competition between legislators, i.e. a “race to the

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35 This economic theory argues that local authorities have an information advantage over central authorities and therefore are better placed to adjust the provision of public goods to the preferences of citizens. Under certain strict conditions, the diffusion of powers between local and central levels of government favour a bottom-up subsidiarity. The economics of federalism deals with the allocation of functions between different levels of government. Tiebout argued that buyers “vote with their feet” by choosing the jurisdiction which offers the best set of laws that satisfy their preferences. The economics of federalism rests upon a number of assumptions. When the “Tiebout conditions” are fulfilled, competition between legal orders will lead to efficient outcomes. There has to be a sufficiently large number of jurisdictions among which consumers and firms can choose. Consumers and firms enjoy full mobility among jurisdictions at no costs. Last, there are no information asymmetries, which on the one hand means that states have full information as to the preferences of firms and citizens and on the other, suppliers of production factors must have complete information on the costs and benefits of alternative legal arrangements. Only in the presence of these information requirements will consumers and firms be able to choose the set of laws which maximizes their utility or profit. Further, no external effects should exist between states and regions. There must be no significant scale economies or transaction savings that require larger jurisdictions (Tiebout, 1956).
bottom”, the need to internalize externalities across legal orders, the achievement of economies of scale and transaction cost savings through extending the size of jurisdiction.

One reason to harmonize national rules is that since these rules differ across countries, they may lead to adverse externalities for other Member States. While such negative externalities can be internalized by harmonization, bargaining between the Member States can also solve this problem. According to the Coase theorem, when property rights are well specified, transaction costs are low and information is complete, bargaining can be an efficient solution (Van den Bergh and Camesasca, 2001).

Another reason in favour of harmonization is that different legal rules carry the risk of destructive competition. Such a “race to the bottom” development has often been linked to and criticized as a result of competition among jurisdictions. It has been argued that competition among legal rules drives social, environmental, cultural and other standards down. This argument has been mainly embraced in international corporate law by making reference to the “Delaware effect”. However, the risk of such declining levels of standards has not yet been proved and the little empirical evidence available is not sufficiently conclusive. Furthermore, international trade may even stimulate a race to the top (G. Wagner, 2005; Van den Bergh and Camesasca, 2001). Gomez also argues that the outcome of such a competitive process cannot be examined without taking into account the relative power of the affected groups (Gomez, 2008). Such competition might not harm powerful and well-organized groups but could have different effects for small and medium-sized enterprises and consumers.

A third argument often raised in support of harmonization is to achieve scale economies and to reduce transaction costs. Transaction costs can be high when firms and consumers have to search and comply with different sets of national rules. In the case of uniform rules, the search costs of information could be saved and complying with one set of rules can achieve scale economies. Uniform competition rules can guarantee more stable and predictable jurisprudence and considerably contribute to transparency and legal certainty (Van den Bergh, 1994).

Furthermore, while uniform rules help to maintain economies of scale, which is an important argument for centralization, they can only be advantageous from an ex ante perspective, when neither the Member States nor the Community have as yet adopted certain legislation. In most areas of consumer contract law, there are few economies of scale. The situation at the moment is that there are 27 well-developed civil codes and also a large variety of consumer regulations, such as those relating to unfair commercial practices. The costs of developing these codes have been incurred in the past and these sunk costs have to be taken into account (Van den Bergh, 1998).
However, while these costs can be especially relevant for large firms operating in interstate commerce, the same might not be true for small and medium-sized undertakings operating mainly in national markets or for consumers. Therefore, as mentioned above, the impact of such harmonization also has to be analyzed, having regard to the relative power of the affected groups.

When all parties in one region have identical preferences, cost-efficiency considerations might point to harmonizing through one single instrument that suits all. This is clearly in line with the preferences of the business community as they are in favour of uniform rules (Van den Bergh, 1994; Van den Bergh, 2002). However, the preferences of consumers can significantly diverge. In fact, it has been argued that the legal systems of the Member States are built through habits, customs and practices which dictate how law is going to be interpreted (Legrand, 2002). The degree of homogeneity/heterogeneity of consumer preferences and the availability of information about these preferences of the standard-setter is a key aspect in consumer law (Weatherhill, 2004).

The above-mentioned criteria of neoclassical economics start from the assumption of individuals’ rational behaviour and stable preferences. Behavioural economics brings a more accurate understanding of individual behaviour and choice concerning legal rules. It focuses on diversity of preferences, stressing cultural differences that are strengthened by cognitive distortions of individuals. Accordingly, it is critical of uniform rules and a top-down harmonization of consumer law (Kerkmeester, 2005).

In sum, there are not sufficient economic arguments in favour of harmonizing consumer contract rules, but there are good economic arguments in support of legal diversity. One such argument is that a larger set of legislations can satisfy a wider range of preferences which leads to allocative efficiency. The broad range of preferences can easily be seen behind the various private law regimes of the Member States, both for substantive and procedural rules. Another argument is information asymmetries that support decentralization by maintaining the principle of subsidiarity and procedural autonomy. When information at local level is more valuable for rule-making and law enforcement, decentralization is more efficient.36

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36 Information asymmetries arise because centralized actors have an information disadvantage compared to decentralized actors with respect to the firms they have to control. As firms may be unwilling to reveal the information needed to central agencies, there is a possibility of providing false information. Therefore, the information obtained might have to be checked and cross-checked against information from competitors, consumers and official sources. Local authorities will have a better overview of the market and thus the firms to be controlled than a supranational authority.
In the following, legal diversity and the effects of competition between different legal systems will be briefly discussed.

7.4 Voluntary Harmonization

Comparative law and economics compares and evaluates the law of alternative legal systems with the “efficient” model offered by economic theory (Mattei et al., 2000; Mattei, 1994). Comparative law and economics deals with “legal transplants” by measuring them with the tool of efficiency and it offers an economic analysis of institutional alternatives tested in legal history (Komesar, 1994). It “deals with the transplants that have been made, why and how they were made, and the lessons to be learned from this” (Watson, 1978). While it offers comparative lawyers the measuring tools of economics, at the same time, it places the notion of efficiency in a dynamic perspective by offering a comparative dimension with concrete alternative rules and institutions (Watson, 1978).

The insights of comparative law and economics offer a dynamic approach to studying legal divergence and convergence and comparing it to the benchmark of efficiency offered by economics. In order to explain convergence between different legal systems that depart from different points it uses economic efficiency to evaluate changes, i.e. so-called legal transplants in a legal system. Convergence between different legal rules towards an efficient model may take place as a result of a legal transplant or as the outcome of a competitive process between different legal formants (Mattei et al., 2000). In the first case, legal transplants are implemented because they proved to be efficient in other legal systems. In the second case, convergence towards efficiency is the result of the interaction between different legal formants. So, while legal transplants are governed by hierarchy, the second scenario is governed by competition among legal formants (Mattei et al., 2000).

The influence of the institutional framework should not be underestimated in measuring actual law enforcement and in understanding why a certain legal rule proves to be successful or fails in different institutional contexts. Neo-institutional economics emphasizes the relevance of institutions and path

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37 Institutions consist of formal and informal rules that determine the behaviour of individuals and organizations. Formal rules such as laws and regulations and informal rules such as constraints on behaviour derive from culture, tradition, custom and attitudes. Formal rules and informal constraints are interdependent and in constant interaction.

38 The relevance of institutions has already been emphasized by Stiglitz, who argued that stages of development indicate how far an economy has advanced in generating the institutions necessary for a well-functioning market economy and the capa-
dependence in explaining the evolution of legal systems where legal change is endogenous or the outcome of a legal transplant. Similar measures will lead to different outcomes because of diverging informal rules and informal constraints in different economies. Institutional path dependency is the downstream institutional choices inherent in any institutional framework and which makes it difficult to alter the direction of an economy once it is on a certain institutional path. Formal rules can be changed overnight, but informal constraints change slowly (North, 1997).

Competition between these legal rules brings with it the advantages of a learning process. National laboratories produce different rules that allow for different experiences and that can improve the understanding of alternative legal solutions. These advantages are relevant for both the formulation of substantive rules as well as law enforcement. Moreover, legal diversity and competition does not necessarily exclude harmonization. In fact, dynamic competition between legal rules can lead to voluntary harmonization, which in turn can be more effective and successful than forced coordination of legislation. Instead of forced harmonization, the Commission could guarantee the conditions for regulatory competition and let this process work up to voluntary harmonization (Van den Bergh, 1996, 2002). Such an informal harmonization can take account of the fact that harmonization is a multi-stakeholder process involving judges, law practitioners, academics and consumer organizations (Poncibó, 2007). Informal harmonization is a process of social learning through conflict management and contestation (Joerges, 2004), which may be the result of dynamic processes of competition between legal orders.

The next section will be devoted to the scope of a possible EU harmonization process in the field of consumer law.

7.5 Harmonization of Mandatory Rules

The pro and contra arguments of harmonization in consumer law have different implications with regard to default rules and mandatory rules. Further differentiation can be made on the basis of the content of mandatory rules (Van den Bergh, 2002; Grundmann and Kerber, 2006).

The core of European consumer law consists of mandatory rules containing information rules. The harmonization of default rules is more a question with...
There is a large diversity of legal institutions in Member States’ private laws. This diversity is a result of fundamental differences in structure, legal philosophy, scientific consideration and language between the contract laws of the Member States. Solutions differ not only concerning the same legal problem, but as regards terminology as well. With regard to default rules, transaction costs and information costs as well as externalities have limited relevance. Default rules are based on the principle of privity and will have little or no effect on third parties and thus externalities are not relevant. Transaction and information costs are lower when parties can choose their contracting law. When European contract rules are offered on an optional basis, rent-seeking plays a minor role as well (Van den Bergh, 2002; Grundmann, Kerber, 2006). Moreover, when uniform rules are imposed, the actual interpretation in national courts might differ. Uniform law cannot be created from above by transposing rules through public policy. Contract rules imposed from above will be enforced and interpreted by further institutions such as courts and regulatory agencies. Designing substantive rules needs to take account of these institutions as well. Harmonization of such rules also needs to take account of the fact that these rules will be enforced and interpreted in diverging institutional settings and thus cannot guarantee uniform rules (Gomez, 2008).

With regard to mandatory rules, transaction and information costs savings are more relevant when a centralized uniform law is available. Uniform mandatory rules save transaction costs and create scale economies. However, such rules cannot serve heterogeneous preferences. Also excluded is the potential for beneficial learning processes between different legal systems. While centralized mandatory rules might be enacted as a tool for correcting regulatory failures at Member State level, there is no guarantee that similar regulatory failures will not occur at central EU level. The EU legislative process and policy making has actually often been criticized for lacking transparency. Rent-seeking in the form of lobbying at the central level can be harmful as well. Moreover, regulatory failures can also be present when bureaucrats enact inefficient rules that have adverse effects on the subjects of the law (Van den Bergh, 2002).

Harmonization of mandatory rules containing information disclosures has a number of advantages. First of all, they intervene less with free market processes than do mandatory substantive rules and they actually create optimal conditions for the exercise of freedom of contract (Grundmann and Kerber, 2006). They can save transaction and information costs. Rent-seeking
is less of a problem as the content of mandatory rules is merely information. However, regulatory failure might still play a role in the form of adopting inefficient or inconsistent rules and piling up legal instruments. Examples of inconsistency can be found in the diverging notions of consumer, information requirements and withdrawal rights in the EU Directives.

Diverging preferences is also a relevant issue in European consumer law as consumers do not have exactly the same preferences throughout all the 27 Member States. A higher level of consumer protection creates costs for sellers, which will be passed on to the consumer where possible. On the one hand, if the consumer receives a higher quality and safer good in return, the increase in consumer protection and price could still enhance consumer welfare. On the other hand, not all consumers are willing to pay more for extra safety or higher quality. A lower income level in one region, for example, could lead to a preference for a certain price-quality trade-off that differs from that preferred by consumers in a region with a higher income. A level of protection exceeding the level preferred by consumers could result in a decrease in consumer welfare, especially in regions where the income level is lowest. Moreover, social norms, degree of consumer activism and transparency of reputation of sellers in markets diverge among different regions. As these issues have a significant impact on the severity of market failures and on consumer protection regulation, decentralized regulation could better incorporate these differences in their respective legal systems and national authorities are better placed to satisfy consumer preferences (Tridimas and Tridimas, 2002). A “one-size-fits-all” instrument like harmonized regulation might not be the most cost-effective instrument for enhancing consumer welfare (Cseres and Luth, 2010).

The implications of behavioural economics for harmonization of consumer rules do not differ from the conclusions of neoclassical economics. Behavioural economics argues for a bottom-up approach to harmonization rather than a top-down approach. The existing diversity of preferences as a result of cultural differences and strengthened by the endowment effect argues against centrally imposed legal rules. Moreover, legislators could also suffer from cognitive distortion and therefore may not be able to filter the distortions of heuristics and biases individual consumers might exhibit. While individual consumers are likely to learn in real market situations about their own cognitive failures and thus learning effects could be substantial, legislators are unlikely to be able to profit from such real world opportunities as

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41 The endowment effect is a hypothesis that people value a good more once their property right to it has been established. In other words, people place a higher value on objects they own relative to objects they do not own (Thaler, 1980).
market parties. Learning processes among legislators are more likely to emerge when diversity and regulatory competition exist. Some individuals may also need more protection than others. All these arguments point to a preference for legal diversity instead of uniformity of law (Kerkmeester, 2005).

When contracting parties face uncertainty as a result of legal diversity and when they have information shortages, coordination problems may arise. Yet, competitive supply of legal rules coupled with institutional meta-rules of mutual recognition and freedom of choice leads to competitive equilibrium. Legal diversity is also an effective constraint on lawmakers’ arbitrariness. Amendment of provisions requires coordination and harmonization with other rules and legal principles and creates chain effects on other provisions and leads to additional legislative fixed costs and adjudication costs (Parisi, 2007).

These different streams of economics point to the fact that legal diversity has potential benefits. The legal system is one of the key institutions of society. There are different methods for measuring the quality of formal institutions such as law and the effects of cross-border legal uncertainty as a result of institutional differences. When different economic and social structures of countries need to be harmonized, substantial costs arise. Competition between legal systems and regulations can accommodate a variety of consumer and enterprise preferences, it can support countries in experimenting and searching for efficient and feasible rules and it can generate a useful learning process. Moreover, such regulatory competition can reduce rent-seeking and regulatory failures. Harmonization of behavioural structures and the forms of realizing formal rules cannot be imposed centrally by public policy, as compliance with the law requires more than just formal institutions. Informal institutions can play a significant role in enforcement, which leads to high information and coordination costs. These costs are less of a problem for large firms; it is small entrepreneurs and consumers who face high information costs and costs of organizing their interests and thus they need harmonized standards or rules (H. Wagner, 2005).

Beneficial spill-over effects between competing European legal systems has been registered in the development of private law in Europe. Comparative law has proved to be a useful mechanism of regulatory competition. Harmonization would destroy these useful effects (G. Wagner, 2005). Comparative law is capable of reducing coordination problems. Impulses from foreign systems and from the EU function as “legal irritants” which can induce useful changes in national law (Wilhelmsson, 2002). Such processes have been started by the Unfair Contract Terms Directive on English law (Teubner, 1998). Legal transplants as a tool of comparative law explains whether legal institutions can be transplanted from one legal system to another (Watson, 1993). Ideas flow through EU legislation as well as directly between Member
States. Piecemeal engineering (Popper, 1957) can serve as a method of harmonization in the form of small adjustments and re-adjustments, offering opportunities for institutional changes with continuous monitoring and improvement (Hage, 2005). “Voluntary harmonization” as a form of decentralization and minimum harmonization leaves room for dynamic competition between alternative legal arrangements (Van den Bergh, 2002). Van den Bergh argues that this mixed system leaves competences with the Member States when the benefits of diversity outweigh the costs of externalities and opportunistic manipulation. Such an approach respects the principle of subsidiarity (Van den Bergh, 1998).

Poncibó also advocates a model of dynamic consumer law that accommodates national regulatory experimentation and consequent mutual learning between EU and national levels. Such reflexive harmonization performs two important functions: it allows rules at national or regional level to be matched to local conditions and preferences, while, at the central EU level, it increases the potential for innovation by maintaining variety within the “pool” of legal solutions to common regulatory problems. Mechanisms that allow the preferences of different users of law to be expressed and for alternative solutions to common problems to be compared enhance the flow of information about practical solutions (Poncibó, 2007).

Competition between legal orders and exchange of legislative solutions or ideas can be realized within the EU-wide network of national enforcement authorities set up by Regulation 2006/2004 on consumer protection cooperation. Like the European Competition Network (ECN), this network can serve as and be extended to a forum for regular contact, exchange of information and consultation on enforcement policy. The Commission could play a central role in the network in order to ensure consistent application of the rules and to moderate the discussion of Member States on different legal solutions to consumer protection issues.

8. SUMMARY

In recent years legal scholars and policy makers have increasingly turned to economics in order to know more about the effects of legal rules on the behaviour of people. Consumer law and policy is no exception to this tendency. Describing and predicting the incentives, risks and effects of legal rules and quantifying the actual costs of consumer protection with the help of law and economics has become a significant part of proposing regulatory tools for consumer protection. Beyond the insights of neoclassical economics and its underlying rational choice theory, the economics of consumer protection has significantly profited from the empirical research results of behavioural
economics. In fact, what this brief overview of the economics of consumer protection shows is that the insights of behavioural economics have posed crucial challenges to the “traditional” approach of economics to consumer protection by questioning not only the basic behavioural model it is based on, but the actual operation and effects of regulatory tools on consumers. The present chapter has discussed several examples of how behavioural economics challenges the regulatory philosophy and the actual effectiveness of present consumer rules. The core issue seems to be the question of whether the legal rules that have been drafted in order to protect consumers in the marketplace are indeed relied on by consumers or if they merely remain unactivated. To answer this question, it seems that both law and economics are increasingly dependent on psychological research about how consumers behave, how they make decisions and choices. This chapter also points to the fact that a new regulatory framework is being designed which is built on simple and concise rules on information disclosure, focusing not only on the content of the information provided but also on the way it is presented and made accessible to consumers.

In the European Union, discussion on the scope and content of consumer protection is further complicated by the harmonization process and the ongoing debate on what should be regulated at a central EU level and which issues should be left to the national laws of the Member States. The dynamism of both debates, i.e. the behavioural challenges and the harmonization of consumer rules, is what today makes studying the law and economics of consumer protection in Europe one of the most exciting scholarly exercises.

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