An economics and effects based regulatory approach to consumer law: the case of EC consumer policy

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Abstract
This paper presents a critical assessment of present regulatory approaches in consumer policy through the analysis of the recently proposed regulatory policy in EC consumer law. This criticism is primarily based on insights from neoclassical and behavioural economics and it argues in favour of introducing an economics and effects based approach in consumer law. It also explains how economic concepts developed in competition law could be cross-fertilized in the design of future consumer policies.

Introduction
The European Commission has adopted a Green Paper on the Review of the Consumer Acquis on 7 February 2007.1 The Review is intended to modernize EC consumer law by simplifying and improving the present regulatory framework. The Commission’s aim is to enhance consumers’ confidence in the internal market and to encourage cross-border transactions by proposing a new regulatory approach based on maximum harmonization and framework directives. Both the goals set out and the measures proposed raise relevant concerns from a legal and economic point of view.

The Commission has emphasized that the aim of the Review “was to achieve a real consumer internal market striking the right balance between a high level of consumer protection and the competitiveness of enterprises, while ensuring the strict respect of the principle of subsidiarity”.2 The Commission has regularly identified the lack of consumer confidence in making cross-border purchases as the core problem that EC 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, it is the consequence of the inconsistencies between the EC directives.

This paper questions the basic ideas behind the Review, namely its underlying goal and the sources of the problems it intends to address. The sources of consumer problems are neither correctly identified, nor it is clear which situations the Review aims to address nor what its envisaged end-goal is. A well defined and workable policy goal and a legally accurate and economically rational standard of reference to achieve this goal are indispensable. The Review sets the aim to increase consumer confidence, however, this paper proposes the adoption of the consumer welfare standard as a more appropriate and workable concept. Furthermore, the paper...
discusses some but not all of the specific issues raised in the Green Paper. These are the notions of consumer and professional, unfair contract terms and enforcement issues.

This paper presents a critical assessment of present regulatory approaches in consumer policy through the analysis of the recently proposed regulatory policy in EC consumer law. This criticism is primarily based on insights from neoclassical and behavioural economics and it argues in favour of introducing an economics and effects based approach in consumer law. Our arguments are primarily based on insights from law and economics, focusing on the effects of legislation and the incentives of the affected market players. It also explains how economic concepts developed in competition law could be cross-fertilized in the design of future consumer policies.

This paper is structured as follows. We first briefly discuss two fundamental issues and then we will answer some of the questions raised in the Green Paper. The two fundamental issues are the goal of the review process and the general regulatory approach to EC consumer law. The next section deals with the economics of information and presents findings of neoclassical and behavioural economics. These two streams of economics are today decisive for how consumer policies are shaped and how strategies are chosen by regulatory agencies. Then we elaborate in more details on specific topics that make use of the theoretical economic literature discussed such as the notions of consumer and professional, the regulation of contract terms and the topical issues of enforcement. We close the paper with conclusions and some suggestions.

The goal of the Green Paper
The Commission has emphasised that the aim of the Review “was to achieve a real consumer internal market striking the right balance between a high level of consumer protection and the competitiveness of enterprises, while ensuring the strict respect of the principle of subsidiarity.” The Commission has regularly identified the lack of consumer confidence in making cross-border purchases as the core problem that EC consumer protection should address. Already in its Green Paper on EU Consumer Protection (COM (2001) 531 final) it has argued that easy access to goods and services promoted, offered and sold across the border allows consumers to optimise their consumption decisions. In turn, it would increase competitive pressure within the internal market and would allow for a more efficient and competitively priced supply of goods and services. 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 harmonisation and on the other hand, it is the consequence of the inconsistencies between the EC directives.

Several points of critique can be raised with regard to the stated goal of the Green Paper. First, the goal the Review process seeks to achieve is not clear. This goal 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 has 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 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.”\(^3\) This means that the consumer problems the Review envisages to address should be precisely defined by providing clear evidence of their nature and magnitude, explaining why they have arisen and identifying the incentives of affected entities and their consequent behaviour.

Second, the goal of the Review as well as of EC consumer protection has to address these actual problems and outline effective remedies. According to the Commission consumers lack the

\(^3\) Case C-376/98 Germany v. Parliament and Council [5 October 2000] ECR-I-8419, para 84
confidence to make cross-border purchases; the source of this problem is claimed to be the fragmentation of national legal rules. The Commission sets a direct link between the lack of consumer confidence and the fragmentation of consumer rules in the Member States (Green Paper 3.3). In doing so the Commission relies on the Eurobarometer Special Report 252. It refers to the fact that about two-third of EU citizens consider that there are more risks or difficulties if they buy goods and services from suppliers in other EU Member States in terms of making complaints, falling victim to fraud, being less protected as consumers and experiencing delivery problems. However, this survey clearly states that “consumers’ attitudes and feelings towards cross-border shopping are often not rooted on actual experiences” and “many respondents formed their opinion on their confidence, concerns and attitudes in these terms on the basis of a limited knowledge and without a personal experience.”

This survey unmistakably shows that it is not primarily the fragmentation of legal rules that is the source of lack of cross-border transactions, but the lack of information. According to the survey there is a remarkable proportion of EU citizens who have no opinion on issues of cross-border transactions as a result of their lack of direct experience. This evidence implies that remediying the fragmentation of legal rules across the EU will not lead to more cross-border consumer activity. Such remedies will not address those consumer incentives that are at stake and are therefore unfit to influence consumer behaviour. However, there are practical factors that the Commission could and should address. These practical problems are related to language difficulties, difficulties in exchanging products, dispute settlements and lack of information. Practical problems like these significantly affect consumers’ willingness and abilities to engage in cross-border shopping. Regulation, in whatever form and magnitude, might not be the best solution to these problems; the Commission could much rather facilitate information disclosure and provision. Theoretical insights from neoclassical and behavioural economics can be applied in order to address market failures more efficiently and effectively and to evaluate the abilities of individuals to acquire and process information accurately. Markets do not always produce an efficient amount or type of information as they are not perfectly competitive. The nature and the distribution of information are essential in order to understand how consumer markets operate. Information is a valuable commodity. Regulation is justified in situations where the theory suggests that the market will provide inadequate information.

Behavioural economics even points to specific heuristics and behavioural biases that limit consumers’ ability to assess risk that should be taken into account when relying on information disclosure solely. These insights will be discussed below in more details.

A well defined and workable policy goal and a legally accurate and economically rational standard of reference to achieve this goal are indispensable. The improvement of consumer confidence as the goal of EC consumer policy and as the aim of the Review is neither a feasible legal nor a workable economic concept. In the following section this paper proposes the adoption of the consumer welfare standard as a more appropriate and workable concept.

**Consumer welfare as the goal of EC consumer law**

Consumer welfare is an appropriate standard as a goal of EC consumer law. This standard is also in line with the Consumer Strategy 2007-2013, where the Commission has acknowledged that “consumer and competition policymakers and enforcers at EU and national level should cooperate more closely to further their common goal of consumer welfare.” In its Consumer Strategy the Commission has pronounced that EC consumer policy should enhance consumers’ welfare in terms of price, choice, quality, diversity, affordability and safety.

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4 Eurobarometer Special Report 252, Consumer protection in the Internal Market, p.55, 79
5 Eurobarometer Special Report 252, Consumer protection in the Internal Market, p. 79
Consumer welfare is generally defined as the maximisation of consumer surplus, which is the part of total surplus given to consumers. This is realised through direct and explicit economic benefits received by the consumers of a particular product or service as measured by its price and quality. Consumer welfare standard can serve as an objective and rational benchmark in consumer law and it can contribute to a better monitoring of what exactly the effects will be or have been of a certain trade practice on final consumers. It can help to enhance economic efficiency, to improve legal predictability and to avoid policy decisions based on abstract risk of obstacles to the exercise of fundamental freedoms or of distortions of competition liable to result from those obstacles.

Consumer welfare standard is today a commonly proclaimed goal of competition policy and a generally applied benchmark of competition law enforcement. There are relevant analytical connections between competition law and consumer law. Competition law and consumer protection take complementary paths to correct market failures and to provide consumers with access to a range of competitively priced goods and services in markets free of unfair and deceptive practices. It is commonplace that competitive markets need active consumers and vice versa. Yet, this fact seems to be more often forgotten than realized by legislators and policymakers.

The experience with the application of this standard in competition law shows several points for cross-references. Comparing the consumer welfare standard in competition law and in consumer law helps to clarify the function of this standard.7

Adoption of the consumer welfare as the benchmark of EC consumer law could encourage the Directorate General Health and Consumer Protection to make use of the economic and legal concepts developed in European competition law, which can provide useful guidelines in consumer law as well. These concepts can be cross-fertilised in consumer law with two relevant limitations: taking into account the different role economic efficiency plays in competition law and in consumer protection and the lack of a supervisory role of the European Commission in EC consumer law. While competition law and policy is an economic efficiency-oriented policy and therefore apt to promote the overall economic welfare of society, consumer law is not only based on economic efficiency but also equity acts as a fundamental principle. Consumer welfare is expressed in both economic and non-economic aspects within the realm of consumer protection and it has almost always a social justice component as well. Competition policy principles can help to steer consumer protection and to ensure that it remains consistent with consumer sovereignty8 and economic efficiency. Making use of these synergies enhances conceptual clarity as well as the effectiveness of policy decisions.

European competition policy has recently come to acknowledge that besides market integration the enhancement of consumer welfare is the ultimate goal of the enforcement of competition rules. This recognition has taken place parallel to the decentralisation of European competition law enforcement and a noticeable policy shift from the form based legal approach to an effects based approach making use of economic insights. The adoption of a consumer welfare standard in EC competition law took shape, in the first place, through endorsing a more


8 Consumer sovereignty is a normative standard against which the performance of markets can be judged. It is a yardstick that implies that, in order to improve the performance of markets, production has to focus on and respond to consumer demands and preferences. The market rules should guarantee that consumer preferences are the ultimate control of the process of production. Kerber, W., Vanberg, V. Constitutional aspects of party autonomy and its limits—the perspective of constitutional economics in: Grundman, S. Kerber, W., Weatherhill, S. (eds.), Party autonomy and the role of information in the Internal Market, de Gruyter, Berlin, 2001, p.54-55
Consumer sovereignty is about the exercise of consumer choice. Consumers are sovereign in the sense of being able to define their needs concerning goods and services, to send a message of their needs to the market and to the producers and to satisfy those needs at a reasonable price and by choosing good quality. Lande, R., Averitt, N. Consumer sovereignty: a unified theory of antitrust and consumer protection law, 65 Antitrust L. J. 713, 1997, p.715
economics based approach that focuses on the actual effects of trade practices instead of the forms of these practices.

A similar policy decision of explicitly endorsing the consumer welfare standard as the ultimate goal of EC consumer law and policy is justified. EC consumer law and policy can significantly benefit from a more economics and effects based approach. Such an approach is also in line with the requirements of Better Regulation, which is the underlying incentive behind the Review. A more economics and effects based approach can rationalise policy proposals and choices for regulatory measures. An economic approach introduces a cost-benefit analysis into the policy framework and it can thereby discipline regulatory interventions. Moreover, a cost-benefit analysis can reinforce and make principles such as proportionality, subsidiarity, necessity and feasibility of intervention hard. Consumer protection is not a zero-sum game; it has its price. The costs of a market failure have to be balanced with the costs of remedying that failure. Before a decision for intervention to correct market failures is taken, the costs and benefits and the impact of that remedy on the behaviour of affected entities have to be estimated. These are costs of legislation, enforcement and compliance as well as potential indirect effects of intervention on consumer and business behaviour. 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 for consumers. As far as 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. A consumer welfare standard can take these distributional impacts into account, unlike the total welfare standard.

Efficiency is a relatively objective and predictive standard as compared to equity. It avoids the uncertainty associated with value judgments about the fair distribution of economic benefits and about determining relative deservingness. It provides quantitative answers to policy questions. Obviously, economic efficiency has its limitations in consumer protection as there are overriding social interests that justify derogations from the economic calculation and because it might be difficult to quantify the benefits of consumer regulation for example when health and safety issues are at stake. Still, economic efficiency disciplines policy-makers to be explicit about and quantify the financial consequences of a policy, to choose the most efficient and effective solution and to avoid excessive regulation. Its application is especially valuable in areas where consumers’ economic and not health and safety concerns are dealt with.  

Regulatory approach to the review of the consumer legislation

The Green Paper proposes three options for regulatory approach. Option 1 is a vertical approach consisting of the revision of the individual directives. Option 2 stands for a mixed approach combining the adoption of a framework instrument addressing horizontal issues that are of relevance for all consumer contracts with revisions of existing sectoral directives whenever necessary and option 3 proposes no revision at all.

A vertical regulatory approach seems justified for the following reasons. The alleged fragmentation in European consumer rules can be well addressed through a case-by-case approach. The inconsistencies between different directives can be eliminated and the basic and

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common underlying notions can be implemented through a vertical case-by-case approach without creating another layer of regulation.

In the Green Paper the Commission makes proposals that address very general lines of its future approach but at the same time there are also very detailed and specific questions put forward. This structure of the proposal questions altogether the definition the Commission attributes to a framework directive. The effectiveness of such framework instruments has been seriously questioned with regard to the Directive on unfair commercial practices. First of all, some of the specific issues that the Commission plans to regulate in the horizontal instrument touch upon intimate parts of national private law. Therefore, agreeing on general standards that all Member States see fit for their own jurisdictions might be either an unfeasible exercise or might lead to norms that have little added value.

Furthermore, such general rules might lead to different outcomes in national legal systems as a result of different implementation methods and diverging interpretations. Although general rules can guarantee a minimum standard of behaviour, they do have significant disadvantages in the implementation phase as compared to specific legislation. Specific, more detailed legislation can have a better direct effect on market participants’ behaviour than general rules, which might be difficult and costly to interpret. General clauses require a strong enforcement mechanism in order to operate properly and to have any influence on the working of the market. Otherwise the strong protection offered by legislation is unenforceable and can outlaw detailed national legislation without providing a sufficient replacement. While these general standards might prove less restrictive of market processes, at the same time they can incur high monitoring and enforcement costs.

It is unconvincing that such horizontal instruments will remedy inconsistencies in the present body of consumer law across directives and national laws or cure consumers’ information problems and save transaction costs for consumers and business. Transparency and clarity concerning legal rules can indeed lead to efficiency gains. Uniform rules can result in a more stable and predictable jurisdiction, while uncertainty will result in additional costs in investigating the legal rules for both business and consumers. Drafting detailed and lengthy contracts terms to overcome uncertainties with respect to court decisions in case the contract terms are challenged will impose further costs on both business and consumers. However, it is rather doubtful whether framework rules will lead to such legal certainty.

The stimulating effect of framework rules on cross-border consumer transactions does not seem justified either. Consumers know little about their rights within or outside of their own jurisdiction. The Eurobarometer Special Report 252 has confirmed that consumers usually act on the basis of their beliefs without being familiar with their national consumer laws and rights. The main barriers faced by consumers are not primarily the understanding of different national rules, but practical matters like language, distance, travelling costs, culture, delivery, after-sales services, mistrust of standards, fear of fraud, access to public authorities and courts and dispute settlements. The findings of the Eurobarometer surveys imply that consumer confidence is not directly linked and influenced by the legal framework consumer and business operate in. Consumers know little about their rights in either national or foreign jurisdiction and therefore there is serious doubt how legal fragmentation and consumers’ knowledge of their rights impact their behaviour. Consumers more often rely on beliefs than on knowledge when they make decisions. It is true that information asymmetry can lead to opportunistic behaviour such as misrepresentation of product quality and thus result in mistrust. It is equally accepted that trust plays the role of a catalyst in most seller-buyer transactions. Trust is especially crucial when

uncertainty and incomplete product information is present in a transaction.\textsuperscript{13} However, this does not directly necessitate harmonization of legal rules. In the following some insights from business and marketing literature will be provided in order to explain how consumer trust works.

Trust can be defined as “a subjective assessment of one party that the other party will perform a particular transaction according to his or her confident expectations, in an environment characterized by uncertainty”.\textsuperscript{14} Trust can greatly improve the effectiveness of markets, whereas the lack of trust especially in case of fraud and misleading practices can create market failures. In the business world trust has three basic sources: familiarity or repeated interaction, calculation of costs and benefits of the other party’s cheating or cooperating and values based on institutional structures that encourage confidence in trustworthy behaviour.\textsuperscript{15} In marketing literature trust is either based on credibility or benevolence. Credibility based trust implies that the other party can perform effectively and reliably according to the explicit and implicit requirements of the contract. This form of trust is impersonal and relies on reputation information and economic reasoning.\textsuperscript{16} Benevolence based trust is present in repeated buyer-seller relationships where the parties are interested in each others’ welfare and they have intentions and motives that are beneficial for the other party. This kind of trust requires familiarity and repeated transactions.\textsuperscript{17} Cross-border transactions are often one-time transactions and the number of transactions concluded through the internet increases. In both cases credibility based trust applies to the context of transactions. In these impersonal one-time transactions the level of uncertainty and the incentives of profit-maximizing firms are high to cheat. Still appropriate feedback mechanisms where agents’ behaviour has reputational consequences can help to improve trust building process.

This short overview of how confidence is approached in other disciplines is not sufficient to suggest concrete regulatory measures, but it does indicate that consumer confidence is not primarily shaped by and linked to the knowledge of legal rules. Therefore, harmonization of consumer laws does not seem to be an appropriate remedy for reducing consumer mistrust in the internal market. The Commission could, however, facilitate finding institutional structures to increase consumer trust in cross-border transactions. It seems that setting up self-supporting intelligent agents to assist consumers in their decision making and effective feedback mechanisms cross-border is a real challenge but can considerably enhance trust building process in the internal market.\textsuperscript{18} Consumers are often not aware of the variety of quality levels and prices let alone the content of legal rules. They need clear reference points to channel their decisions to socially optimal choices and towards their own personal preferences.

It is not the maximum or the minimum level of consumer protection that can increase consumer confidence but how information about consumer protection rules is provided and distributed to consumers. It is not the harmonization of legal rules throughout the EU what consumers need but the reassurance that they will be protected, have rights of redress and the actual ability to take action against sellers when their rights are violated. Furthermore, the number of cross-border transactions does not seem to be an adequate indicator of qualifying the functioning of the internal market. Cross-border competition among firms might be a cause of the low number of consumer transactions.\textsuperscript{19} Therefore, the Commission should pay

\textsuperscript{13} S. Ba, P. A. Pavlou, evidence of the effect of trust building technology in electronic markets: price premiums and buyer behaviour, \textit{MIS Quarterly}, Vol.26 No.3, p.244
\textsuperscript{14} ibid p.245
\textsuperscript{15} ibid, p.246
\textsuperscript{16} ibid
\textsuperscript{17} ibid
\textsuperscript{18} ibid, p.247; Poiesz, Th.B.C. The free market illusion: psychological limitations of consumer choice in Market regulation: lessons from other disciplines, Ministry of Economic Affairs, 2004, The Hague, p.29
equal attention to both firm and consumer confidence to offer and to purchase goods and services cross-border.

A horizontal instrument may act as an additional burden on industry, which can hinder market developments, increase business costs and might even reduce business incentives to trade cross-border. Community legislation will only be (cost-)effective if it is based on the principle of proportionality. The principle of proportionality stands for the avoidance of intensifying existing problems. Unnecessary restrictions for businesses might be counterproductive. The trade-off between restricting competition and trade and lowering information costs seems to be approached in an ineffective way by a framework directive. Business responses have articulated these concerns in the consultation process concerning the Directive on unfair commercial practices. The Commission cannot evade business interests. Doing so can have far-reaching negative consequences once a framework directive is agreed upon without taking business interests seriously into account: it can paralyse competition.

The additional costs new rules generated for business will very likely be passed on to consumers. This cost increase will have to be balanced with the increase in cross-border demand and supply of goods and services in order to prove that new rules are indeed necessary. The costs of such a vertical approach are estimated to be lower than the costs of the horizontal approach. A horizontal approach with framework directives might require further legislation, implementation and interrogation on the side of the Member States, while a systematic assessment of existing laws could be carried out at lower costs both at EU and at Member State level.

The current European consumer protection rules are not unsatisfactory. They focus on specific and significant issues of consumer protection. Instead of creating a new layer of regulations, the quality of legislation and the implementation of legislation should be improved. We suggest that the vertical approach should focus on implementation by controlling the proper and effective transposition of the rules and on enforcement by assessing the practical and actual enforcement and application of the rules by consumers. Until the Commission provides an in-depth cost-benefit analysis of legal diversity, on the one hand, and of harmonisation, on the other, and clearly proves that harmonisation is more cost-effective than legal diversity, there is no reason to work on a harmonised European law and no reason to believe that such a harmonised law will improve the present situation.

Which level of harmonisation?
The Green Paper proposes two options: full harmonisation complemented on issues not fully harmonised with a mutual recognition clause or minimum harmonisation combined with a mutual recognition clause or with the country of origin principle. Minimum harmonisation combined with a mutual recognition clause or with the country of origin principle seems to correspond the best with the goals and the feasible realization of the Review.

With regard to the level of harmonization the Commission should respect the principles of subsidiarity and proportionality. These principles would be the best safeguarded if the degree of harmonization is determined on the basis of efficiency. Efficiency should be the primary guideline when competences between Member States and the EU are divided and the level as well as the means of harmonisation is chosen.

The specific issues in the Green Paper relate to contract law and tort law, which are areas under the almost exclusive competence of the Member States. There is a large diversity of legal solutions in the area of private law. This diversity is a result of fundamental differences in structure, legal philosophy, scientific consideration and language between the contract laws of the

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Member States. Not only do the solutions differ concerning the same legal problem, but terminology as well. This fact confirms the need to rely on the subsidiarity principle, namely that private law legislation can be better enacted by lower levels of government than higher levels.

Neo-classical economics offers a number of criteria to judge whether centralisation or decentralisation is more successful in achieving the objectives of the proposed action. Economic reasons in favour of centralisation are: the danger of destructive competition between legislators i.e. “race to the bottom”, the need to internalise externalities across legal orders, the achievement of economies of scale and transaction cost savings through extending the size of jurisdiction.

Externalities may be a reason to centralise decision-making. Negative externalities occur when Member States issue policy decisions that have adverse external effects for other states. Pollution is an obvious example. When scale economies are important, like in the case of national defence, centralisation may again be a better solution. Transaction costs in the case of different rules may be high, while in the case of uniform rules the search costs of information could be saved. These costs might be very important for private firms operating in interstate commerce, but the same might not hold for consumers. Uniform rules can guarantee more stable and predictable jurisprudence and may significantly contribute to legal certainty.21

Economic reasons in favour of decentralisation are: the need to cope with information asymmetries between the centralised and decentralised actors i.e. the European Commission and Member States, the possibility to gather information about the costs and benefits of alternative legal rules, which is generated by competition between legal orders and diverging preferences in the respective regions or other social differences that influence the effectiveness of regulation.

Information asymmetries arise because centralised actors have an information disadvantage compared to decentralised actors with respect to the firms they have to control. As firms may be unwilling to reveal information needed for 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.

Competition between different legal orders can serve as a learning process. Trial and error is very useful to find the best solutions to complex legal problems. Different rules imply different experiences and can help to improve the understanding of the effects that alternative legal solutions have in similar legal problems. This advantage is present both in substantive and procedural rules.22

Diverging preferences is a third factor that could tip the balance in favour of decentralisation. When all parties in one region have identical preferences, cost efficiency considerations might point to harmonising through one single instrument that suits all.23

With regard to the level of harmonisation of consumer protection, the arguments pro and contra harmonisation have the following implications: contract law does not always exhibit externality problems. Some contracts only have consequences for the parties to the agreement; some might have external effects to third parties. These external effects might be, for example, environmental problems, nuisance caused by noise or waste. Problems of this kind are better dealt

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with by regulation like tort law, environmental law, and the like. The problems consumers face when engaging in contracts are more connected with the fact that parties are not informed or not sufficiently informed. Scale economies and uniform rules indicate that a more harmonised instrument will be more efficient. This would point towards total harmonisation. Information asymmetries between centralised and decentralised actors, however, call for minimum harmonisation. Local authorities, within the Member States, have better access to information regarding the firms they control. A supranational authority like the European Commission is at a disadvantage in this respect.

Competition between legal orders and exchange of legislative solutions or ideas can be easily fulfilled by the EU-wide network of national enforcement authorities set up by EC Regulation 2006/2004 on consumer protection cooperation. Similarly to the European Competition Network (ECN) this network can serve as 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.

As to diverging preferences, consumers do not have exactly the same preferences throughout all Member States. As mentioned above, 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 different from the one that consumers in a region with a higher income would prefer. A level of protection exceeding the level preferred by the 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 significant impact on the severity of market failures and on consumer protection regulation, decentralised regulation could better incorporate these differences in their respective legal systems. A “one-size-fits-all” instrument like harmonised regulation might not be the instrument that is the most cost-effective or efficient in enhancing consumer welfare.

The typical approach in the field of consumer law has been minimum harmonisation. On the one hand, minimum harmonisation allowed Member States to introduce stricter rules than the European standards and thereby to maintain and defend their legal cultures and traditions. On the other hand, Member States still remain limited in their policy decisions by the principle of proportionality and by the mutual recognition doctrine. Total harmonisation has been developed in the field of technical standards, where directives contain mandatory basic requirements and provide for a framework for the elaboration of non-binding technical standards elaborated by European standardisation organisations. This approach has mainly focused on the need for European business to obtain uniform European standards, as these standards facilitate trade between Member States and promote the completion of the internal market.

We acknowledge the fact that recently the need to protect consumers has been explicitly linked to the establishment of the functioning internal market mainly as a reaction to the ECJ’s ‘Tobacco Advertising’ judgement24 and the ‘Tobacco Labelling’ judgement25 that reaffirmed the strict interpretation of Article 95 as a legal basis for measures of harmonisation. Still, we hold that total harmonisation will not necessarily increase the protection or the welfare of consumers. Such an approach requires exceptionally difficult and time-consuming negotiations among the 27 Member States. It involves complex legal, social, cultural and political issues that require ample

25 Case C-491/01 British American Tobacco v The Queen [2002] ECR I-11453
work to form into common principles. Producing common standards that would attract widespread support from business and consumers in all the Member States seems to be unfeasible and might lead to solutions that are the result of political compromises instead of careful legal and economic considerations. Such an approach might sacrifice the higher levels of consumer protection and welfare in certain Member States in order to meet lower levels of protection for the sake of total harmonisation.

Total harmonisation leaves little or no room for the 27 kinds of particularities in the cultural, political, linguistic or legal determinants of consumer behaviour, consumer needs and expectations. Economic analysis argues that different legal rules can satisfy the heterogeneous preferences of a larger scale of people and therefore improve welfare.

Therefore, minimum harmonisation combined with a mutual recognition clause or with the country of origin principle seems the most efficient way to pursue consumer welfare.

In the following we introduce theoretical insights from neoclassical and behavioural economics on information failures and remedies. The economics of consumer protection is largely concerned with the economics of information and therefore it is indispensable to have a short overview about the theoretical background before we elaborate on more specific problems of consumer protection.

Economics of consumer protection: economics of information
Consumer law is a more effective instrument of consumer protection when it prevents or deters unlawful conduct rather than provides a remedy for loss or damage. The advantage of preventive measures is that they can avoid the social costs of compensating consumers after the event and that they focus on collective consumer interests, while remedial consumer law is aimed at the compensation of individuals. Accordingly, regulations could rather concentrate on empowering market players to make rational and efficient choices rather than protecting weak dummies. This can be achieved by primarily focusing on information provisions about price, quality, the nature and consequences of consumer transactions. Information provisions are often considered as effective means to cure information asymmetries and assist consumers in their decision-making process. Neoclassical economics provides useful insights on how information affects the dynamics of markets, the determinants of bargaining and drives regulatory approaches of consumer protection to a more effects and cost-benefit based analysis. The assumptions of neoclassical economics, however, treat key aspects of consumer decision making as exogenous and as such can say little about the amount, the nature of and the way information should be framed and disclosed to consumers. Behavioural economics based on empirical research deals with endogenous aspects of consumer decision-making and questions present policies for consumer protection. Insights from neo-classical economics on information asymmetry, adverse selection, moral hazard, transaction costs as well as recent findings of behavioural economics about systematic cognitive errors of consumers’ decision making have relevant implications for designing new regulatory frameworks and setting priorities for regulatory agencies. Both streams will be briefly reviewed below.

Neoclassical economics focus on market failures originating from information failures. It identifies the sources of information deficiencies and thus consumer harm either in the lack of competition or in the fact that information is unavailable or not costless or in uncertainty of individuals about the quality of product characteristics. Uncertainty can originate from incomplete or inadequate information. This can lead to information asymmetry problems, where one party possesses the information about a certain product or service characteristic whereas the

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other party does not. 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. Goods can be classified based on the consumer’s ability to determine quality into search goods, experience goods, and credence goods. Search goods quality is easily evaluated before purchasing the good, 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 the danger of quality deterioration. Quality reduction in a market can be caused by market failures, like adverse selection or moral hazard.

Uninformed consumers are usually confronted with informed sellers. When consumers are not fully informed of the quality of goods they cannot distinguish between poor and good quality goods. As consumers are not able to compare the quality of the offered goods they compare their prices. Assuming an average quality, consumers will eventually purchase from producers offering the lowest prices. Producers will have to reduce the costs of production and accordingly the quality of their products if they want to stay in the market. Producers offering high quality goods at higher prices will be forced to leave the market and so poor quality goods drive out good quality goods from the market. Akerlof has shown exactly this process of adverse selection in his famous article “The market for lemons”.

The more difficult it is to determine the quality of a product, the more information about the quality of that product will need to be provided in order for the consumer to make an informed decision to offset the market failure of information asymmetry and subsequent adverse selection, which can be relevant to all product characteristics.

Information problems can be solved through uninformed consumers’ screening or sellers’ signalling. Screening is when uninformed consumers search for information on their own or with the help of third parties with special knowledge or capabilities. Insurance brokers or estate agents are good examples. In the case of signalling sellers show that they are interested and that they offer high quality. Signals can be warranties, reputation, brands, advertising or franchising, but they will only succeed if sellers of high quality goods use them. 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 accruing from that competition to consumers but might at the same time facilitate collusion among firms.

Information asymmetry cannot 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 a service have to be weighed against the benefits of that added information. The search costs of acquiring and using information and the opportunity costs of time have to be weighed against the expected benefits.

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28 Credence goods include the purchase of services offered by liberal professions, like lawyers or physicians. It can sometimes be even more difficult to ascertain the quality of these services. The consumer is forced to trust the supplier of the service as it is impossible to assess the quality of the good through the repeat purchase mechanism.
29 Akerlof, G. The market for ‘lemons’: quality uncertainty and the market mechanism, 84 Q. J. Econ. 488, 1970 pp.487-500
30 Information suppliers may have special equipment or experience in evaluating goods and their information costs are lower than the same costs of consumers. They can even control the producer’s behaviour after the contract has been signed.
32 This is referred to as rational apathy, a term originating from political science literature explaining why people do not vote.
The effects-based approach taken in the law and economics literature focuses on the consequences of laws and regulations, especially on the behaviour of the affected parties. A valuable message from economic analysis is that consumer protection comes at a cost. Mandatory allocation of risk, mandatory disclosure duties and other obligations will create additional costs to producers and sellers, who will pass these costs on to consumers where possible. A price increase could then lead to a decrease in choice, especially when lower-income groups in society will no longer be able to purchase certain products. Not all consumers prefer the same product characteristics; some might prefer a lower quality if the price is sufficiently low to balance the decrease in quality. Moreover, providing protection can undermine the individual responsibility of the consumer and may encourage careless behaviour. Moreover, it may cause consumer moral hazard problems, implying that consumers take advantage of certain obligations imposed on firms and professionals. An example of consumer moral hazard would be buying a certain good from a doorstep seller with no intention of keeping it longer than the cooling off period, but using it in the meantime.

Neoclassical economics starts from a number of assumptions such as market players have stable set of preferences and they make consistent and rational choices in order to maximize their own welfare. However, recent empirical findings of behavioural economics challenge these assumptions on the basis of examining what people actually do how consumers analyse, interpret and use product and service information. Consumer preferences seem to 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 where they seem 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. Consumers will only look for and process a certain amount of information. As a consequence individuals fail to maximize their welfare under specific circumstances. As a consequence individuals fail to maximize their welfare under specific circumstances and they take short cuts when making decisions leading to choices that might be inconsistent with promoting their own welfare.

The theory of bounded rationality argues that the capacity of the human mind to conceive and process complex information is relatively limited. Behavioural or experimental economics found that consumers may rely on heuristics instead of being guided by rationality. The new research showed that decision-makers systematically 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. 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

34 The extent to which this is possible depends on the price-elasticity of the demand for this particular product or service, see Cooter R, Ulen T. 1996. Law and Economics. New York: Harper Collins. 2nd ed., pp. 29-30.
36 R Smith, S King, Does competition law adequately protect consumers?, ECLR 2007, 28 (7), p.416
38 Herbert A. Simon, supra note _, pp 261, 270-271 (1957)
41 OECD, Roundtable on economics for consumer policy, Summary Report, DSTI/CP(2007)1/FINAL, p.11
information overload. Most people are overoptimistic about their abilities or their prospects and providing them with better or more information will not necessarily make them take the appropriate action. People overestimate the \textit{ex ante} prediction that they had as regards the likelihood of an event’s occurrence on the basis of information about what actually did occur. This is called the hindsight bias. People can also be overconfident that a certain event will not happen to them, although they are aware of the actual probability distribution of that event.\footnote{Ulen, T.S. Information in the market economy – Cognitive errors and legal correctives in: Grundman, S., Kerber, W., Weatherhill, S. (eds.), \textit{Party autonomy and the role of information in the Internal Market}, de Gruyter, Berlin, 2001, p.117} 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 deteriorate market transparency, a situation referred to as “confusopoly”.\footnote{J Gans, “The Road to Confusopoly,” available on the ACCC conference Website at http://www.accc.gov.au/content/index.phtml/itemId/658141/fromItemId/3765.} Empirical studies in recently liberalized markets showed high degree of consumer inertia and indicated that many consumers despite the optimal balance between search, switching costs and expected gains are not taking advantage of beneficial switching and, in some cases, are switching to higher-cost suppliers.\footnote{Giulietti, M. C. Waddams Price and M. Waterson, Consumer choice and competition policy: a study of UK energy markets, 115 \textit{The Economic Journal} 2005, p.949-968; C Wilson, C Waddams, "Irrationality in Consumers' Switching Decisions: when more firms may mean less benefit, CCP Working Paper 05/04, ESRC Centre for Competition Policy, University of East Anglia, 2005} Even when comparative information is available to consumers this inertia may be explained by computational difficulties, perceptions that search costs are high, or by possibly misplaced trust in consumers’ present supplier. Thus consumer confusion and “information-overload” are rather the reasons for these mistakes than other “rational” explanations of consumer mistakes such as perceived differences in firm quality or uncertainty over consumers’ own demand.\footnote{C Wilson, C Waddams, "Irrationality in Consumers' Switching Decisions: when more firms may mean less benefit, CCP Working Paper 05/04, ESRC Centre for Competition Policy, University of East Anglia, 2005}

Decision-making heuristics cause consumers to underestimate benefits of searching and switching, for example in case of endowment bias consumers value more what they have than what they might have or in case of hyperbolic discounting when they rationally do not weigh present gains against future benefits and put too much weight on the immediate. Framing biases originate from the specific ways objective information is provided.\footnote{OECD, Roundtable on economics for consumer policy, Summary Report, DSTI/CP(2007)1/FINAL, p.12}

The implications for consumer protection policy and lawmaking differ in the case of neoclassical economics and behavioural economics. The difficulty lies in the fact that the predictions of the neoclassical model are often elegant, but prove to be wrong when empirically tested and evidence from behavioural economics research is difficult to channel into a useable taxonomy for regulation but it is more likely to be accurate.\footnote{Thaler RH: Toward a Positive Theory of Consumer Choice (1980) \textit{Journal of Economic Behavior and Organization} 1 39-80} In order to determine whether to intervene and how to intervene to assist consumers a complex array of issues has to be taken into account. Not only the costs of intervention, but also the costs imposed on business and the different groups of consumers (informed, sophisticated, uninformed and vulnerable) have to be considered. Regulatory tools imposing measures that ultimately diminish competition that increases consumer choice should be avoided. Highly complex systems of information disclosure originally aiming at lowering information costs will obviously restrict competition and will have counterproductive effects. Consumers unable to make informed choices are forced to employ expensive intermediaries and business has to bear the costs of the ineffective disclosure. Some consumer protection measures create barriers to entry that limit the freedom of sellers and might eventually lead to higher prices for consumers. Interventions therefore should be evidence-based, focused and evaluated to ensure that it is not unnecessarily applied. It should be examined why
the market-based solution does not work or why that solution might be socially sub-optimal.\textsuperscript{48} It also has to be demonstrated why government regulation is going to be better than markets in providing low-cost information. Even where a relevant market failure has been identified, government should only act when this is feasible and it is cost-effective to do so. The costs and benefits of particular forms of intervention and alternatives thereto should be examined and represented. Consumer regulation will only make consumers better off if it either improves consumer estimates of the value of information or reduces the cost of information to consumers.

Neoclassical economics identifies consumer detriment in the presence of market power of suppliers and encourages remedies such as vigorous competition policy enforcement.\textsuperscript{49} However, simply increasing competition does not always lead to optimal market circumstances for consumers as experience in the liberalized markets proves. Information deficiencies are still present and may lead to consumer harm in competitive markets as well. Neoclassical economics encourages more and better information to remedy market failures on the demand side, such as mandatory disclosure or third-part certification. The notion of consumer adhered to in consumer policy should therefore be compatible with regulation aimed at remedying the market failure of information asymmetry. In what way the notion of consumer could be adapted to correspond to an economics and effects based approach in consumer policy will be assessed below. 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 suggests that intervention should be imposed with a “lighter hand”.\textsuperscript{50} It suggests remedies aimed at framing effects and thus steer consumers’ choices towards welfare enhancing options.\textsuperscript{51} Paternalistic guidance towards certain options through framing the way information is provided could assist consumers to debias their decision-making and to channel their decisions to socially beneficial options.\textsuperscript{52} Below such an example will be explained with regard to standard contract terms.

In sum, economic theory sees a clear role for government intervention in the case of a market failure, like information asymmetry. However, as this intervention comes at a price, the costs of the intervention have to be weighed against the expected benefits. Regulators should be aware of the costs of protection and in particular the possible consequences consumer protection regulation might have on the behaviour of respective parties. 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 stimulates the individual responsibility of the consumer. European consumer law should continue to address information failures in market transactions in order to prevent inefficient transactions. However, the above insights and evidence from recent empirical research should guide the European regulatory approach. A regulatory framework based on theoretical and empirical research evidence would be desirable. Casarosa et al. urge for some kind of governance design to streamline the body of consumer law and the regulatory techniques of harmonization.\textsuperscript{53} Another possible framework could be a checklist and toolkit for consumer policy, similar to what is being worked on presently within the OECD.\textsuperscript{54}

\textsuperscript{48} These are self-correcting mechanisms that are based on private law norms of tort, contract and property rights that they are the result of government action. Hadfield, Howse, Trebilcock (1998, p.155)
\textsuperscript{49} R. Smith, S. King, Does competition law adequately protect consumers?, ECLR 2007, 28 (7), p.417
\textsuperscript{50} OECD Roundtable discussion on private remedies: class action/collective action; interface between private and public enforcement, United States of America DAF/COMP/WP3/WD(2006)34, p.18
\textsuperscript{51} R. Sunstein and R.H. Thaler, "Libertarian Paternalism Is Not An Oxymoron" (2003) 70 The University of Chicago Law Review, Fall, 1159
\textsuperscript{52} OECD Roundtable discussion on private remedies: class action/collective action; interface between private and public enforcement, United States of America DAF/COMP/WP3/WD(2006)34, p.18
\textsuperscript{54} OECD, Roundtable on economics for consumer policy, Summary Report, DSTI/CP(2007)1/FINAL, p.37
The notions of consumer and professional

The concepts of “consumer” and “professional” vary among the different directives covered by the Review.\textsuperscript{55} According to the Green Paper, this inconsistency creates uncertainty and confusion needs to be remedied by adopting one clear definition of both concepts.\textsuperscript{56} The question remains whether these concepts should be wide or narrow. The narrow notion would define consumers as natural persons acting for purposes that are outside their trade, business or professions, and professionals would be defined as persons (legal or natural) acting for purposes relating to their trade, business and profession. The wider concept would include natural persons acting primarily outside (consumer) or primarily within (professional) their trade, business and profession. This paper proposes a new approach: the notions of consumer and producer should correspond to the market failure addressed by consumer policy, namely information asymmetry. As discussed above, providing information is an effective remedy for this market failure, though it is not necessarily sufficient. Bounded rationality and rational apathy influence often limit the way available information is included and interpreted in the individual decision making process. Regulation concerning information disclosure should take the effects of information disclosure on both firm and consumer behaviour into account.

The definition that would correspond best to correct this market failure needs to address the information asymmetry that exists between the two parties to the contract, whether this involves a “normal” consumer contract or a “mixed” contract. A normal contract involves a consumer and a professional party, whereas a mixed contract can involve two professionals, one of them acting outside the field of his profession. The example employed in the Green Paper to elaborate on the concept of a mixed contract involves a doctor buying a car to use both professionally (visiting patients) and privately. This doctor, although clearly a professional, lacks information about the quality of the car and lacks skills to easily assess this quality. The subject matter of this specific transaction is neither familiar to the doctor as he is not repeatedly engaging in such a transaction nor does he have specific knowledge about it. When the doctor is buying a car, he or she does not differ in his decision-making mechanism from any other consumer. Moreover, the information asymmetry that creates a market failure to the detriment of consumers would continue to exist even if the doctor would buy a car to use it only professionally.

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 regulation. 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. Extending the example used in the Green Paper, a doctor could 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.

The definition of consumer and professional should therefore be widened even further to contain all situations in which the seller has an information advantage over the buyer. 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 contract.\textsuperscript{57} This definition also incorporates corporate bodies and companies who act outside their field of


\textsuperscript{56} See supra, note 1, page 15

\textsuperscript{57} See Aquaro, Enhancing the Legal Protection of the European Consumer, 14 European Business Law Review 3, pp. 405-413.
expertise and therefore possibly lack relevant information in comparison with their contracting partner. 58

A second question posed in the Green Paper in relation to the notion of consumer and professional is to what extent contracts between a consumer acting through a professional intermediary and another consumer should be governed by consumer protection regulation. Assuming that the party who hired the intermediary for his services is looking to sell a good, there exist at least two contracts in this scenario: a first contract between the consumer-seller and the professional intermediary, and a second contract between the consumer-seller and the consumer-buyer. The real question therefore is whether a consumer-buyer acting outside his field of expertise, not assisted by an intermediary, should be protected by consumer protection regulation. The private party who purchases or uses the services of the professional intermediary can take advantage of the knowledge, skills and experience of the intermediary. The information asymmetries call for protecting the stand-alone consumer in this situation from unfair consequences due to the contract, whether imposed by the intermediary or the consumer-seller. The costs of this protection will be taken into account in the price of the second contract. How the obligations from granting consumer protection to the consumer-buyer are divided between the consumer-seller and the intermediary can be arranged in the contract between them, and the price for the service can be adjusted accordingly. 59

**Fairness of terms in consumer contracts**

The economics and effect-based approach argued for in this paper can also be applied to the subject of fair terms in consumer contracts. Three specific issues in relation to the fairness of terms in consumer contracts are raised in the Green Paper: extending the scope of the discipline concerning unfair terms in consumer contracts to cover individually negotiated terms, the status of a possible list of unfair contract terms included in a horizontal instrument and a possible extension of the fairness test to cover price and main subject matter of the contract. This section will start with a general discussion of the economic analysis of standard terms in consumer contracts, before addressing the questions raised in the Green Paper.

Contract terms, and especially standard terms in consumer contracts, will be known by the professional party, but are not likely to be known by the consumer. This is a typical case of information asymmetry. The unequal bargaining power, take-it-or-leave-it nature and

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59 As professional services are not governed by this Review, the issue of protecting the consumer-buyer protection when hiring the services of the intermediary will not be further elaborated. Some comments can be made however with respect to whom the consumer-buyer should be given protection and with respect to which party can the consumer-buyer invoke his rights? The intermediary is in a better position than both other parties to search and assess information with regards to the contract (quality, hidden defects, contract terms, etc), and the first point of contact for both other parties. He is therefore the cheapest information provider, and would be in the best position to grant protection to the consumer-buyer. It would be less costly and troublesome for the consumer-buyer to invoke his rights *vis-à-vis* the intermediary as opposed to *vis-à-vis* the probably unknown consumer-seller. The reputation constraints faced by the professional intermediary and the risk faced in the contract provides an incentive for the intermediary to search, analyze and provide information to the both consumers. Of course this influences the first contract, as concluded between the private party and the intermediary. The division of risk from liability will be expressed in the price for the intermediary services.
standardization of contracts have given rise to scepticism regarding the fairness of standard terms. However, in the classical law and economics literature, these issues do not pose serious challenges. 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. As profit-maximizing sellers do not want to lose consumers, they will adapt their standard forms to correspond to the preferences of the majority of their customers. Furthermore, a “duty to read” clause endorses that parties to a contract will be held responsible for their own decisions, counteracting consumer moral hazard problems. Consumers themselves are in the best position to maximize their own welfare. The doctrine promotes stability and reliance on contracts, even if the contract turns out to be less beneficial than was estimated by one of the parties before. “Duty to read” as well as the general economic approach focuses on the ex ante perspective more than the situation ex post. Standard terms allocate risks between consumers and businesses. The “best” allocations of risks are unlikely to vary between businesses, and the standard forms used by different firms allocating these risks will be comparable. Standardization is therefore not a clear sign of unfairness of the standard terms; full information and allocation of risks corresponding to consumer preferences could also result in similar standard terms throughout the business sector.

However, a single consumer could choose to free ride on the efforts of other consumers. Without incurring any costs for assessing standard terms herself, she could benefit from other consumers reading the standard terms. Efficient terms would be adopted in the standard forms without any costs to this consumer. 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, not even by informed consumers who form a sufficiently large group to induce welfare enhancing standard terms. 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 remains high. Consumers lack the skills and capacities of accounting for including more than only a few salient product attributes in their decision making process, like price, colour, type, warranty period, etcetera. Some of these salient product attributes can be individually negotiated terms. Consumers are subject to rational apathy: they do not notice or interpret all contract terms, but are attracted to the salient product attributes. It is therefore in the best interest of sellers to offer non-salient standard terms at as low costs as possible, enabling a price-reduction.

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. A welfare enhancing contract term would allocate risk with the party that is most able to influence that situation from occurring and place responsibility for certain actions with that party who is most able to induce them at lowest cost. Furthermore, it should correspond to the risk preferences of the parties to the contract. To exemplify, a standard term could specify that in case of damage resulting from delivering a household appliance to the house of a customer the store should be notified in writing within three days. The majority of consumers, upon thinking

about it, could 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 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 damage made 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 sellers for the favour of the consumer only affects salient product attributes. As price is a salient product attribute, competition between sellers 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 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.

Reputation is questionable as a mechanism to induce welfare enhancing standard terms. Sellers can waive a specific standard form or term if a consumer complains. This saves reputation, but does not allow all consumers to benefit from less one-sided terms. Only consumers who complain accrue the benefits, even though not all consumers would take the trouble of complaining if they expect the firm to invoke the unilateral term against them. Also, standard terms often allocate remote risks. Consumers might not learn from businesses invoking these terms against their customers, creating little or no effect on the reputation of the firm. Lastly, businesses might also be managed by managers who are only interested in short term profit, and not by long term reputation considerations. For all these reasons, the market is likely to produce low-cost and one sided, not necessarily welfare-enhancing, standard terms. A consumer welfare standard could very well require standard terms to be regulated, for instance by providing a black list of standard terms that are particularly onerous and could unlikely raise consumer welfare.

The issues raised in the Green Paper concern extending the discipline of unfair contract terms to cover individually negotiated terms, the status of a possible list of unfair contract terms included in a horizontal instrument and a possible extension of the fairness test to cover price and main subject matter of the contract. These three issues can be discussed from an economics and effects based approach.

With respect to standard terms in consumer contracts, a clear case for government intervention exists on the basis of information asymmetry and adverse selection. Consumers, subject to rational apathy, fail to account for all standard terms in their decision making process, let alone reading the terms carefully. This leads to adverse selection in the form of only low cost and low quality terms being included in the standard contract. Some of these low quality terms could be onerous. A list of unfair terms can provide guidelines/reference points to judiciary 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, decrease 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 the 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 main subject matter, as well as individually negotiated terms are by definition salient to the consumer, and as such part of the

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66 Ibrahim, D.M, Rewriting the Law of Boilerplate Terms: Fairness, Efficiency, and a Standard Form Principle of Comparative Responsibility, available at SSRN:
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 would be consumer welfare reducing. The consumer is able to base her choice on available information in case misrepresentation is absent and no market failure exists. 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 would 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.

Extending the scope of the discipline of unfair contract terms to cover individually negotiated terms could result in consumer moral hazard problems. Responsibility for assessing ex ante the desirability of a particular transaction should lie with both contract partners, the seller and the consumer. The consequences of a transaction should be evaluated before the contract is entered into. This argument is a prerequisite for being able to conclude welfare enhancing contracts. Focusing on both seller and consumer responsibilities corresponds to EC Consumer Policy strategy 2007-2013, which states that: “confident, informed and empowered consumers are the motor of economic change as their choices drive innovation and efficiency.” 67 Carelessness on the part of consumers can be induced by a allowing consumers the possibility to invoke the fairness test against any contract term. Carelessness before entering into contracts would not stimulate welfare enhancing transactions to be concluded.

Extending regulation to cover individually negotiated terms could also lead to a decrease in options available for negotiations. A consumer could conceivably prefer to have a certain risk allocated to him in exchange of a price premium. If this risk occurs, the consumer could then seek a remedy against this individually negotiated term, claiming it to be unfair. Consumers are not subject to costly consequences of loss of reputation as sellers are, and therefore less inhibited from opportunistic actions. 68 As sellers can expect this kind of moral hazard on the part of consumers, they are not willing to offer certain kinds of contract terms to consumers. If these contract terms would be available to consumers, they could only be agreed upon after a lengthy negotiation process. The seller will insists upon several assurances drafted in the contract to make sure the fairness test cannot successfully be invoked against the negotiated contract term. Uncertainty, extensive negotiations and extra drafts lead to an increase in transaction costs. Instead of protecting the consumer, an extension of the fairness test to cover negotiated terms could bar some terms from ever being agreed upon, which infringes the freedom of choice, reduces the availability of options and delays transactions to materialize.

When negotiated terms remain excluded from the discipline of unfair terms, less protection seems to be offered to active consumers than to inactive consumers. As stated above, consumer protection includes protection against unfair terms while maintaining freedom of choice and enabling a variety of options. As active consumers know what they bargain for, unfair terms will not be agreed upon, save in cases of misrepresentation. Active consumers are well protected by the doctrine of misrepresentation, thus only suffering a decrease in welfare when they are denied the possibility to negotiate the terms they prefer. Consumers might err when negotiating for certain contract term, mistakenly agreeing to a term that decreases their welfare. This issue should be balanced with problems connected to consumer moral hazard, the incentive to thoroughly assess the consequences of one’s actions and decisions to prevent error and the decline in available options to consumers. Consumer error is not a sufficient rationale for

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mandatory legislation, especially when adverse effects of that legislation are taken into account and protective legislation might even induce consumer error. However, behavioural insights also be taken into account. As behavioural literature details, 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 her 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 by 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 and at the same time reducing the consumers’ options remains to an open question until further evidence is found. Other policy options could be targeted at more efficient ways of dealing with consumer biases.

A model of standard terms that enhance welfare for the majority of consumers might be more efficient in providing protection to consumers. Default rules, and as such model rules, tend to be sticky and have an expressive effect. 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 an anchor or reference point, from which she is more reluctant to deviate to the risk division she would have had in mind absent the default. This is particularly relevant when discussing negotiated standard terms. Policy makers might be more efficient in remedying market failures by resorting to instruments like model standard terms or certificates for standard terms to influence the decision making process of consumers who choose to negotiate standard terms. Particular attention should be given to those terms that allocate risks between parties. Most individuals tend to be risk-averse, whereas professionals and companies are to be regarded risk-neutral. Model terms governing the contract should follow these risk preferences allowing a departure from the defaults upon expressed wish of the consumer. Likewise, consumer moral hazard should explicitly be taken into account in order to counteract adverse effects of regulation, such as an increase in transactions costs passed on to consumers.

Alternative policy options could include a certificate for a “fair set” of standard terms, a grading scale for the fairness of standard terms, or stimulating the drafting of model standard forms as a result of negotiations between business and consumer interest groups. 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 to be included into 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 to medium enterprises would arguably be ready to free ride on the drafting efforts by other parties and also adopt the model form, ensuring a fair set of terms throughout the business sector. Further research should be conducted on analyzing the efficiency of alternative instruments to influence the formation of standard terms in consumer contracts. However, these alternative instruments might be more effective in inducing welfare-enhancing terms in consumer contracts than purely relying on competition between sellers to attract consumers combined with (mandatory) legislation.

70 See Becher (2007), supra note 61, for a discussion on several options, like a certificate for fair standard terms. In the Netherlands, the Social Economic Council (SER) hosts negotiations between business and consumer interest groups to draft model standard forms for consumer contracts.
Enforcement

The Review of consumer protection is incomplete without discussing enforcement and access to justice. The challenge for finding effective and low cost ways for consumers to resolve their disputes and to provide access to remedies that are not disproportionate to the economic value at stake have become one of the key challenges of consumer policies at national, European and international levels. If the Commission is seriously concerned about consumer confidence and consumer welfare then this challenge should be one of the priorities of its future consumer protection strategy.

While the Commission does not have a supervisory competence in the field of consumer law, enforcement issues are becoming relevant discussion points in EC consumer law as well. Previously Directives in the consumer protection field have left enforcement of the law entirely to the Member States. Directive 98/27 EC on injunctions and Regulation 2006/2004 on consumer protection cooperation have squarely put the issue on the top of the consumer protection agenda.

This discussion on the enforcement of consumer rules has been very similar if not identical to the discussion on effective enforcement methods in competition law (Green Paper Damages actions for breach of the EC anti-trust rules, COM (2005) 672 final). The objectives of the enforcement of competition law and consumer law partly coincide as they both aim to achieve deterrence and efficiency. Both set of rules are aimed at effectively influencing and imposing a meaningful impact on corporate policy and behaviour. While the underlying legal rules and the subject matters differ there seems to be numerous insights that merit broader consideration and cross-fertilization in both fields.71

The development of European law that has evolved along the lines of the Injunctions Directive and the Enforcement Cooperation Regulation has, on the one hand, led the discussion to finding effective means of collective consumer redress providing an efficient supplement to individual redress schemes such as small claims procedures and ADR. On the other, the deterrent effect of currently available remedies and sanctions has to be reviewed. The question whether the present set of remedies and sanctions that mostly comprise injunctive relief and administrative fines should be extended to recovery of damages. How to make private enforcement a valuable complement to public enforcement colludes again strikingly with the policy issues in competition law. The issue of providing consumers with meaningful compensation for damages suffered as a consequence of “anti-consumer” or anti-competitive practices can provide useful insights in both areas worth of cross-fertilisation. An effective institutional framework is equally important to achieve an efficient system of consumer redress. Whether it is public authorities or private organisations who take consumers by their hands can make a difference not only for consumers but for business, too. While the underlying legal rules and the subject matters differ there seem to be numerous insights that merit broader consideration in both fields.

The assessment and the design of the various procedural models have to take account of the underlying substantive issues in order to provide consumers such enforcement tools that are capable to address the market failures, repair the damage and prevent future violations of consumer rights. Accordingly, enforcement methods should be designed and selected by studying the various ingredients that determine their actual operation. These ingredients include the nature of consumer concerns (health, safety issues or economic loss as result of for example information problems), practical matters such as economic incentives, financial resources but also time and ease of access to justice and last but definitely not least the remedies sought (declaratory, injunctive or monetary remedies) and deterrent sanctions (criminal law or civil law).

The central issues that are being discussed are the efficient balance between private and public enforcement, individual redress schemes, collective actions and besides injunctions the

possible adoption of damages actions. Among these issues private enforcement and collective damages claims are topical.

In most European jurisdictions the present set of remedies for consumer offences is limited to declaratory remedies and injunctions. Monetary remedies in the form of damages claims can provide consumers with compensation for damages suffered as a consequence of “anti-consumer” practices. When a consumer offence causes economic losses some kind of action for claiming damages seems justified as well as efficient to remedy harmed consumers.

Private enforcement in any field of law is a highly debated topic at the moment. From a law and economics perspective, the main issue is whether consumers have sufficient incentives to invoke remedies against professional parties. 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. Individual consumers face costs and burden 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 the injured individuals who will not sue. Private actors are much more influenced by costs and benefits than public bodies enforcing the law. Policy decisions on encouraging private enforcement of the law has to take account of the fact that 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.

Another concern is that private interests do not always coincide with public interests. Therefore private parties might lack the incentives to litigate, which in turn results in less enforcement or they may exceed the level of litigation which is socially desirable and optimal. In other words, private enforcement carries considerable risk of both under-deterrence and over-deterrence. Private enforcement does not always and not necessarily meet the socially desirable level of litigation.

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 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. In a recent Eurobarometer survey in the 15 old Member States 67% of the European Union citizens indicated that they 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.\textsuperscript{72}

Bundling these fragmented individual claims can also considerably enhance law enforcement. It is argued that collective actions have a higher probability of preventing future harm to consumers and thus has a stronger deterrent effect than individual claims. Moreover, it 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 business and the courts as well.

Nevertheless, the adverse effects of collective actions are also well-known. These adverse effects call for an approach that develops mechanisms that on the one hand, aggregates and consolidates claims and provides an efficient manner to bring these claims to courts and to adjudicate these claims. On the other, an approach is needed that can avoid excessive litigation and provide consumer meaningful compensation. Such a system will need to be based on “strict management” and on an optimal coordination between private and public enforcement.

\textsuperscript{72} Eurobarometer, European Union citizens and access to justice, October 2004, p.36
Such a strict management could make use of the recent reforms taken in the US in order to ameliorate its class action system and which clearly attempts to impact on indirect purchaser actions. The Class Action Fairness Act (CAFA)\(^{73}\) enacted in 2005 takes considerable measures to make indirect purchaser actions less burdensome and more manageable.

Optimal coordination between private and public enforcement could include deciding on issues like who would be a rational tortfeasor. While the adverse effects of class actions, such as contingency fees and unfavourable settlements might disappear when a consumer organization or other association brings damages claims, other limitations become clear. Consumer organisations enjoy the advantage that they can stay close to the marketplace, have easy access to information from individual consumers and they are less subject to capture and principal agent problems. However, they often lack the resources and powers of detection and investigation as well as the means to bring claims to civil courts.

Therefore, while public intervention should be limited and decided on the basis of a cost-efficiency, their expertise, investigative powers and sanctions might be indispensable and necessary. In the EC 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 co-ordinated 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 such as competition authorities and public consumer protection agencies should be further explored.

Finally, the two suggestions follow for what the Commission could do in order to improve the level of consumer protection and the level of regulation. On the one hand, it should study the gap between the law on the books and its actual enforcement. It is not enough to provide the legal tools. The economic and social settings of the application of the rules have to be explicitly set out before new rules are adopted. While this might be valid as a general guideline in the enforcement of law, the economic and social context of consumer rules and the behaviour of consumers have a more direct impact on the actual success of legislative models. Without studying the practical problems and the psychological circumstances of consumer decisions it seems difficult to draft legislative or other tools that can increase consumer activity and improve substantive and procedural options. Such a study actually needs to take into account the economic resources, appropriate incentives of both supply and demand side.

On the other hand, facilitating consumer protection needs to be based on the improvement of the institutional capacity of consumers and their organizations. This in turn requires investments in consumer advocacy, “consumer policy R&D”\(^{74}\), academic infrastructure, education in law and economics, professional associations and consumer groups who can contribute to disseminate consumer but also competition principles.\(^{75}\) The Commission could play a central role in assisting the Member States to create such an infrastructure. Moreover, for laws to be effectively enforced, it is important to understand what strategies individuals and

\(^{73}\) 28 U.S.C. Sections 1332(d), 1453, and 1711-1715


undertakings choose to operate under the law. To that end, the impact of laws and regulations on private actors’ behaviour should be studied and evaluated when new policy decisions are made.

Conclusions and suggestions for the way forward
This paper has reviewed the basic underlying principles behind the Commission’s Green Paper on the review of the consumer acquis and some of the specific issues that were included for discussion. Our conclusions and suggestions can be summarized in four points.

First, the improvement of consumer confidence as the goal of EC consumer policy and as the aim of the Review is neither a feasible legal nor a workable economic concept. This paper proposed the adoption of the consumer welfare standard as a more appropriate and workable concept, because this policy standard would introduce a more effects and economics based approach in European consumer law. Even though economic efficiency as a benchmark has its limitation in consumer law it can, however, contribute to a more cost-benefit conscious regulation, enforcement and policy-making. Useful lessons have been drawn from the application of the consumer welfare standard in EC competition law.

Second, this paper advocates a vertical case-by-case regulatory as more effective in terms of costs and benefits and which can more efficiently target the present inconsistencies and fragmentation of legal rules among the member States. There seems to be no hard economic or empirical evidence that argues in favour of a horizontal approach. Similarly, there are good economic arguments for maintaining a minimum level of harmonization in EC consumer law instead of total harmonisation. There is a clear need for consistent and thorough systematisation of the present body of consumer acquis. This, however, should not take from through adopting new rules but to design a substantive and institutional structure within which an efficient governance design can be developed.

Third, the above advocated economics and effects based approach calls for taking lessons from neoclassical and behavioural economics seriously. This implies, for example, a wide definition of consumer based on concerns related to information asymmetry. The definition should contain all situations in which the seller has an information advantage over the buyer. Consumers can therefore 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 contract. Contracts between a consumer acting through a professional intermediary and another consumer should be governed by consumer protection legislation, so that the stand-alone consumer is protected from unfair terms and can claim compensation for damages. Obligations from granting consumer protection to the consumer-buyer are to be allocated in the contract between the consumer-seller and the intermediary.

Information asymmetry and adverse selection give rise to market failures with respect to standard terms in consumer contracts. This market failure, combined with bounded rationality problems, can result in the drafting of inefficient standard terms. A “duty to read” will not lead to welfare enhancing standard terms per se. Black and grey lists can provide guidelines and reference points to the judiciary regarding the unfairness of terms. However, black and grey lists as well as the fairness test only bar the most onerous terms from being drafted into a consumer contract. A term that is not particularly onerous can still be welfare decreasing for the majority of consumers.

When no information asymmetry exists, for example, with respect to price, main subject matter and negotiated terms, government intervention is more likely to decrease consumer welfare than increase it. Increasing the scope of the discipline of unfair terms could result in consumer moral hazard problems, a decrease in options available, and increase transaction costs. Cognitive errors in decision-making should be taken into account, but might be more efficiently addressed by other policy options like a certificate for “fair” standard terms or composing a model form of standard terms.
Fourth, a relevant part of consumer policy making, namely enforcement issues are completely absent from the Green Paper. There are significant questions related to public enforcement, ADR and private enforcement as well as remedies and sanctions that would be an indispensable part of this review process.

In sum, a modest but significant role in the Review process should be taken up by the European Commission to further consumer welfare. The Commission is well-placed to advocate a consumer welfare standard by introducing a more economics and effects based approach and to stimulate the Member States to act similarly. The Commission is also well-placed to remedy the present situation where consumers lack information about cross-border transactions. The Commission could maintain a database on both the EU and the national consumer rules, cases and policy actions. It could assist solving problems that cannot be tackled by Member States individually as well as coordinate the consumer protection developments in Member States. Providing consumers with information and assisting them to process and use that information seems the most effective tool to ensure a high level of consumer welfare. Furthermore, the Commission can play an important role in stepping up overall enforcement efforts in consumer law.