

The economics of self-regulation in solving consumer quality issues

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FOREWORD

The economic issues raised by self-regulation are not commonly discussed by national competition authorities or consumer enforcement bodies. Nor have they been significantly addressed by the academic economic literature. These issues are, however, of real interest and this paper lays out our current thinking.

It is outside the scope of this paper to provide a full assessment of all relevant aspects of relevant competition or consumer law. We do not attempt to explain the legal framework here; nor do we represent the OFT's view of what is permissible within this framework.

Instead, we have focused on the role self-regulation can play in making markets work well for consumers, in particular in terms of the quality of products and services they receive. In particular, we look at how self-regulation can affect incentives for both consumers and suppliers when it is otherwise difficult for consumers to assess, and for suppliers to signal, quality prior to or even after purchase.

This paper is an economic discussion paper. The ideas contained within are thus not intended to be definitive but rather are designed to promote discussion and to further economic thinking on the issue of self-regulation.

This report is part of the OFT's Economic Discussion Paper series. If you would like to comment on the paper, please write to me, Amelia Fletcher, at the address below. The OFT welcomes suggestions for future research topics on all aspects of UK competition and consumer policy.

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1 EXECUTIVE SUMMARY

INTRODUCTION

- 1.1 For the most part markets function well without the need, within a basic legal framework, for either external or internal intervention. When markets are not functioning well, however it can sometimes be in an industry's interest to 'regulate' itself and by doing so improve outcomes for consumers.
- 1.2 Self-regulation schemes appear in a broad range of markets; from goods to services, from electrical products to food stuffs, from instant products to ones delivered with time delays. This paper focuses, in particular, on what motivates industries of all different types, sizes and maturity to form self-regulation schemes and why they can be beneficial to consumers.
- 1.3 Self-regulation can have significant benefits to consumers so long as any gains are not negated by factors such as detriment to competition. Competition concerns can arise because by its nature self-regulation involves businesses collectively altering or agreeing to alter their behaviour and this can provide opportunities for anti-competitive practices, such as foreclosure or price fixing.
- 1.4 In this paper self-regulation is defined as initiatives made by groups of businesses within an industry to take action to improve quality standards,¹ which are, at least in some part, driven by a voluntary self-interest² from industry (a profit incentive).

¹ There is no universal agreement on the definition of self-regulation. Definitions will vary and are often tailored to specific purpose or context. For a recent alternative definition see Ofcom – initial assessments of when to adopt self- or co-regulation consultation March 2008. A broader definition can also be found in Compliance partnerships: An OFT consultation on developing the use of 'established means'. December 2008. OFT1043con

² Voluntary self interest is an interest that would come about even in the absence of any regulatory threat

- 1.5 Although under this definition, self-regulation schemes need, at least in some part, to be driven by a voluntary self-interest from industry, this does not mean that self-regulation is defined as having no involvement from external regulators or enforcers. Importantly, schemes may still benefit from (or need) external involvement.
- 1.6 In solving quality problems schemes are often a form of industry-led compliance (because consumer protection legislation also seeks to solve some quality problems). Schemes can thus have benefits in being able to deliver for consumers (potentially more effectively) what enforcers might otherwise have sought to.³ In addition schemes can sometimes offer extra benefits to consumer by going beyond legal compliance, for example by pursuing higher levels of quality or higher levels of redress than are stipulated in consumer law.⁴
- 1.7 The focus is on self-regulation to solve quality problems. Industries' desire to solve market failures unrelated to quality (which then benefit consumers), could lead to similar economic characteristics and cross industry structures. These are, however, not considered within this paper, (for example, cross licensing patterns or technical agreements⁵).
- 1.8 Finally, although this paper focuses on the incentives of industry to self-regulate, sometimes government also has an interest in bringing about a form of 'self-regulation' through a government sponsored arrangement. Government sponsored arrangements seek to encourage producers to tackle issues in order to achieve wider policy goals (including, sometimes, goals which are not related to quality or which may not be in industry's self-interest). Under these types of arrangements producers

³ In this way, self-regulation schemes can be seen as supporting the enforcement of existing consumer law.

⁴ Although it should be noted that if quality is set higher than the statutory minimum it might not always be beneficial to consumers as quality could then be too high.

⁵ Technical standards might, for example, be that all mobile phones can communicate across networks.

may, for example, be encouraged by government to collectively address issues in areas such as environmental standards, food safety, and health.⁶

PROBLEMS OBSERVING QUALITY

- 1.9 If self-regulation is a solution to quality problems, what are these problems? Quality is important to consumers when they make decisions about which goods and services to buy and how much to pay for them.
- 1.10 Sometimes, however, consumers find it hard to judge the quality being offered by suppliers. This problem is known as 'asymmetric information' primarily because suppliers know quality but consumers do not.⁷
- 1.11 It can be particularly hard for consumers to judge quality if an important aspect of the good or service is not observed until after the purchase or is never revealed. This includes situations where it is difficult for consumers to be sure that the business will stay in the market long enough to deliver on their promises.
- 1.12 These problems observing quality can be exacerbated because quality is a multifaceted concept and consumers will usually be concerned not just with inherent quality features, such as the material used, but also with wider aspects such as after-care or sales service.
- 1.13 When consumers cannot judge quality, businesses may find it hard to credibly commit to high quality since they might have an incentive to say they are offering high quality even if they will actually offer low quality. This in turn can mean consumers expect low quality, irrespective of quality promises, and it can mean that (some or all) high quality products disappear from the market.

⁶ This paper does not, in the main, consider these arrangements although a very brief discussion of broader applications can be found in section 6.

⁷ The issue of suppliers being unable to observe an individual's unique taste and an asymmetry of information where consumers know quality but providers don't is set aside.

- 1.14 This can be bad for consumers, since there is no high quality option available for them to purchase with confidence (and especially bad for them if they pay for high quality without receiving it).
- 1.15 Both individual businesses and consumers have strong incentives to find solutions. Businesses have an incentive because otherwise they miss out on potential profits from higher quality sales. Consumers have an incentive because they want to be able to buy high quality and they do not want to get stung paying for high quality but receiving low quality.

INDEPENDENT MARKET-BASED SOLUTIONS AND CONSUMER LAW

- 1.16 In many situations, market-based mechanisms (without the need for a group initiative) can provide powerful ways for businesses to independently solve quality problems. In particular, markets offer businesses the ability to build market reputation. Market reputation means that there is potential harm to businesses if they lie about quality (fewer people buy in the future or are willing to pay less) and potential gain to businesses if they offer reliable quality signals (more people buy in the future or are willing to pay more). The promise of future sales can provide the incentive for businesses to be honest about quality so they do not harm their future sales.
- 1.17 Reputation is not the only solution; warranties, guarantees, and redress schemes, can make it less profitable for businesses to lie about their quality. Deposit protection schemes can protect consumers against supplier insolvency and thus against the very low quality that results when a business fails. Meanwhile, access to informed advisors and to advice can enable consumers to better observe or infer market quality.
- 1.18 There are limits to these independent market-based solutions. In particular; consumers may not trust warranties; advice can be costly for consumers; advertising can be costly for suppliers; and suppliers may not individually be able to develop a reputation, due, for example, to a lack of repeat purchase or 'word-of-mouth' recommendations. An inability to develop reputation is particularly likely for small businesses for whom the costs of doing so are likely to be comparatively greater.

- 1.19 There may also be coordination problems with independent market-based solutions. Although it can be in the industry's interest as a whole to resolve quality problems (so that more consumers enter the market or are confident to pay higher prices), individual businesses can lack the incentives to make quality efforts due to free rider problems. Businesses can free ride on the efforts each other make to improve quality if consumers can only identify market quality and not which business is making the effort. This means that businesses acting individually may under-invest in quality.
- 1.20 Consumer law also helps to solve problems with observing quality by, amongst other things, compelling businesses to provide their stated quality level and in some instances stipulating that certain quality levels are too low and should not be allowed in the market⁸.
- 1.21 In some situations, however, the enforcement of consumer law may not be the best instrument. Enforcement may not be enough due to costs involved in pursuing it; it may not be sufficiently tailored to problems within certain industries; and it cannot go beyond enforcing the letter of the law.

SELF-REGULATION AS A SOLUTION

- 1.22 Self-regulation schemes typically involve groups of businesses committing to provide a certain quality standard via, for example, a code of conduct. These schemes 'regulate' member businesses to make sure that they all meet the quality standards which are set and/or that no member lies about the quality that they will provide.
- 1.23 Independent market-based solutions, consumer law, and self-regulation essentially all seek to resolve problems with observing quality by helping to offer better quality signals to consumers, or by providing businesses with stronger incentives not to lie about quality, and to some extent

⁸ Value of goods and supply of services legislation implies that goods must be of 'a satisfactory quality' and that services must be carried out with 'reasonable care'.

consumer law and self-regulation also helps to solve problems by making it less important that consumers observe quality by monitoring it for them.

- 1.24 Self-regulation may be a better instrument than consumer law or independent market-based solutions, in particular, if they are able to more easily or more effectively: go beyond what is legally required; tailor rules and guidance to specific industry problems; overcome free rider effects; allow businesses to share costs of redress and reputation building; and rely less than independent market-based solutions on the actions of individual consumers and businesses.
- 1.25 To have the potential to generate benefits, self-regulation schemes need to meet overarching requirements⁹. First, that those businesses which sign up meet the standard set. Second, that they have enough/the right members to have an impact. In practice this means that schemes need to be able to monitor quality and sanction bad behaviour; and ensure that the benefits to membership for individual businesses outweigh the costs. (In voluntary self-regulation schemes, an important benefit will often be that consumers are aware of the scheme and choose to purchase from it.) Any benefits which are generated from self-regulation must of course not be negated by factors such as detriment to competition.
- 1.26 Schemes that cannot get businesses to meet the standards set may offer a false quality signal to consumers. False signals of quality are dangerous as they could 'mislead' consumers into making inappropriate purchase decisions.

⁹ In practice there are many principles that could provide guidance to generating successful self-regulation outcomes. This section does not drill down into operational or policy criteria, but it sets out two important overarching principles for self-regulation schemes.

COMPETITION CONCERNS

- 1.27 Effective self-regulation can play an important and beneficial role in allowing businesses to commit to providing products and services of a particular quality. Self-regulation also has the potential to enhance competition, if it enables more businesses to exist in the market and/or leads to greater competition on quality. In particular, self-regulation can make it easier for smaller businesses to compete, who could individually struggle to overcome the costs of committing to quality or find it harder to establish a reputation.
- 1.28 On the other hand, there can be risks to competition from self-regulation. Self-regulation can provide opportunities for businesses to engage in anti-competitive practices (such as price fixing, or raising barriers to entry so that they are unnecessarily high).
- 1.29 The process of self-regulation can open the door for businesses to restrict competition, either explicit collusion or tacit collusion. In addition, quality requirements or standards could themselves dampen competition, in particular by raising barriers to entry. For instance, this could occur if self-regulation results in requirements that benefit some businesses at the expense of others; if quality standards are set too high; if businesses gravitate towards one quality level; restrictions are placed on conduct; or undue protection is provided to inefficient businesses.
- 1.30 Generally concerns over competition might be less where: (a) the market is open and competitive or (b) there is limited chance of the self-regulation having an appreciable effect on competition. For instance, an appreciable effect on competition is less likely if the proportion of businesses involved in self-regulation on a given market is small, or if only one aspect of quality competition is affected.
- 1.31 Nonetheless, the very nature of self-regulation means that it is likely that competition, or at least some aspects of competition would be restricted. Consequently it will be important that the parties assess, if necessary by taking independent legal advice, whether self-regulation is

likely to result in a restriction, distortion or prevention of competition within the meaning of the Competition Act 1998 and/or Article 81 EC and, if so, whether the exemption criteria set out in the Competition Act and/or Article 81(3) EC are met.¹⁰

INTERACTIONS BETWEEN EXTERNAL REGULATION AND SELF-REGULATION

- 1.32 External regulators can have an important role to play in making sure self-regulation is as effective as possible and that any risks to self-regulation are minimised. First, they can do so by increasing the benefits to joining or forming a self-regulation scheme, sometimes through the credence and support offered by Government endorsed schemes, and sometimes through altering incentives via threats or compulsion to join a scheme.
- 1.33 When regulators engage to promote self-regulation in ways which go above and beyond the normal enforcement under consumer law it is likely to be resource intensive. Regulators might therefore be expected only to exert additional effort to promote self-regulation where it is likely to generate most benefit to consumers.
- 1.34 Circumstances in which regulators are more likely to encourage the industry to move towards self-regulation include:
- a) industries where quality is never revealed: in these industries independent market-based solutions may be less likely to resolve issues since reputation is harder to build;
 - b) industries where there are relatively more small suppliers: small businesses can find reputation harder to build and hence in these

¹⁰ It is outside the scope of this paper to provide a full assessment of all relevant aspects of the competition law. We do not attempt to explain the law here; nor do we represent the OFT's view of what is permissible under UK and EU law. The assessment of whether self-regulation schemes meet the exemption criteria must be made on a case by case basis, following legal advice. The OFT provides more guidance in this area on its website.

industries independent market-based solutions may be less likely to resolve issues;

- c) when consumer detriment would be high even with appropriate levels of normal consumer law enforcement in the market; and
- d) when there are checks and balances in place to mitigate against any risks to self-regulation: this ensures that benefits to consumers are more likely to be realised.

- 1.35 Second, regulators can help self-regulation by strengthening the environment in which genuine schemes flourish. For instance, under the Consumer Protection from Unfair Trading Regulations 2008, it would be a misleading practice if a trader indicates that he is bound by a code of conduct but fails to comply. It is also a banned practice to claim to be a signatory to a code but not be a member.
- 1.36 Third, both competition and consumer law provide a general legal backstop against which all self-regulation schemes operate. Competition law prohibits and sanctions self-regulation which, on balance, has a negative impact on competition. It should, for example, protect consumers by preventing unjustified restrictions on entry or price competition. Meanwhile, consumer law can compel entry to certain self-regulation schemes and general consumer enforcement prevents and deters businesses from lying about quality and punishes them when they do.
- 1.37 The form self-regulation schemes take will be important to regulators who want to consider their possible impact. Two overarching considerations about form are (a) whether schemes are compulsory or voluntary (where compulsory means due to a government mandate a business must be a member of the scheme to operate in the market) and (b) whether there is a single scheme or multiple schemes in a market.
- 1.38 In general, voluntary schemes are preferable in markets where niche businesses want to signal quality and go above the letter of the law as such schemes offer greater flexibility. Compulsory self-regulation is likely to be of particular value when consumers do not shop around

and/or detriment is high if they receive low quality, or when voluntary schemes can not gain enough coverage to sustain themselves or be influential in the market.

- 1.39 There can also be trade-offs between multiple schemes in an industry or a single scheme. In general multiple schemes might be preferable to a single scheme because they are less likely to be harmful to competition and offer greater consumer choice. If however, the market is complex and information on schemes is hard for consumers to obtain and understand or if multiple schemes can not generate enough revenue to sustain themselves, single schemes may be preferred.
- 1.40 The advantages that self-regulation may have over external regulation are predominately that it may be better placed, able or resourced to provide effective regulatory solutions. For instance, schemes can have better knowledge of markets and can thus act more quickly or provide better monitoring, can be more flexible and more responsive to market changes, can save on government regulation costs or impose less regulatory burden, and can go beyond the letter of the law.
- 1.41 Pursuing self-regulation as an alternative to external regulation can, however, also have disadvantages. Predominately this is that while external regulators can align interests closely to those of consumers a self-regulatory body might have interests and objectives that are not closely aligned with those of consumers. Not least temptations towards anti-competitive practices. Overall the impact on consumers of self-regulation is likely to depend on this degree of alignment of interest between schemes and consumers.

CONCLUSION

- 1.42 Self-regulation schemes can bring benefits to consumers and may do so in a way that is preferable to external enforcement. In particular, self-regulation can play an important role in improving the market functioning in areas that are not a priority for regulators and save on enforcement costs by acting as a form of industry-led compliance. Self-regulation schemes may also offer further advantages by going beyond legal

compliance in particular because they can set higher standards than required by consumer law. There are however risks, specifically that competition could be harmed or that ineffective self-regulation could serve only to 'mislead' consumers by offering false quality signals.

2 PROBLEMS OBSERVING QUALITY

- 2.1 Self-regulation typically aims to solve a problem arising from poor quality, of one sort or another. Quality problems occur because quality can't always be perfectly observed or assessed by consumers. This can be detrimental to consumer as markets do not deliver the levels of quality that consumers want, even though consumers would be willing to pay for it.
- 2.2 This section highlights circumstances when consumers will find quality difficult to judge and explains why it can be problematic, leading to quality levels which are lower than both industry and consumers would desire. Later sections talk about possible solutions including those available through self-regulation.

OBSERVING AND ASSESSING QUALITY

- 2.3 The price someone is willing to pay for something depends, in part, on the quality of the product or service. For instance, consumers are likely to be willing to pay significantly more for a well tailored silk dress than for a factory produced cotton one. Further, because most consumers can fairly easily (and with little cost) tell the difference between a well tailored silk dress and a factory produced cotton one (by feeling the material and checking the stitching), the relative prices of the dresses are likely to broadly reflect their relative quality.

Box 2.1: What is meant by quality?

Quality does not just include the physical product or service being immediately provided but can be more broadly defined to include, customer service, information provided and the after sales care¹¹. Quality can partly be derived from the inherent features of the product or service, such as, the cost of the materials used and the cost of the techniques used to assemble them (or the cost of training the service provider).

Quality is, however, arguably more than the inherent features. It is also, to some extent, the utility that individual consumers get from a product. This means that it could vary from person to person depending on their tastes, preferences and expectations.¹² Quality therefore cannot always be ranked from low to high (basic to superior), with everyone preferring superior if the price were the same. For instance, some consumers might think that uPVC window frames are higher quality than wooden windows frames because wooden ones need maintaining and others that wooden windows frames are higher quality than uPVC window frames because they prefer the look of wood.

Which aspect of quality is important will vary from product to product. The quality of a battery, for example, is likely to be mostly determined by the inherent qualities and limited to the battery itself. Whereas quality of a sweater is likely to be more complicated, determined not only by inherent features like the materials used, but also by the individual's tastes, and the sales service provided by the retailer.

¹¹ Mark Armstrong similarly defines quality broadly '*The term 'quality' can be interpreted very broadly and encompasses hidden chargers in the small print, unexpected exclusions in insurance contracts, and so forth*' Mark Armstrong for the OFT 'Interactions between competition and consumer policy – Economic discussion paper' April 2008. OFT991

¹² Fuller explanation for example, can be found in: 'Competition policy – Theory and Practice' by Massimo Motta. Cambridge University Press. 2007 (8th edition). Or 'Price and Quality in a New Product Monopoly' – Judd and Riordan - The Review of Economic Studies, Volume 61, Issue 4 (Oct, 1994) 773-789

2.4 Quality, however, is often complex and is a broad multifaceted concept (as set out in **Box 2.1**) A broad definition of quality means that even the simple case of observing quality when buying a dress becomes more complex as consumers might also need to consider, whether the dress was made from ethical materials, whether the dress could be returned, how durable it would be, and how much pleasure they would get from it. All of which are harder to judge than simply feeling the dress. In particular, it is not always easy or indeed possible for consumers to completely observe or assess all aspects of quality because:

- a) **Acquiring information on quality (or assessing it) can be costly or difficult.** For example, when buying a laptop to ascertain quality a consumer would need to research memory size, processing speed, compatibility, graphics card etc. This information is not obvious from looking at the laptop and it can be complex. Consumers who wish to ensure that they get the best laptop for their needs and given their budget, need to invest some time and money (buying computer magazines, looking up technical terms etc) to ascertain quality. If the time and effort is too great, or the information too complex, some consumers might never accurately observe quality. This argument is compounded by evidence from behavioural economics which suggests that some consumers may be boundedly rational in their decision making, facing limits to their ability to process and compute decisions (even if all the information is available).

- b) **Consumers can't judge quality until after they've experienced the good/service**¹³. For example, it is hard for a consumer to tell: the quality of a haircut before they've had it done¹⁴; how good an apple

¹³ Economists call this an experience good. See, for example, Nelson, P. 1970 Information and consumer behaviour. *Journal of political economy* 78:311-328

¹⁴ Even if you stood outside the saloon watching others it would be hard to know who had requested an ill-suited style and who been given it as a result of the hairdresser's lack of skill.

tastes before they eat it; how good the after-sales customer care is when they lose their mobile phone until they lose it; or how long an electrical good will last until they have used it for a few years.

- c) **In some circumstances consumers won't be able to judge quality even after they've experienced the good/service¹⁵.** For example, most consumers taking their car to be repaired won't ever know if the new exhaust pipe they were charged for was necessary or if the new spark plug they were charged for was actually new. Quality matters even if consumers are unaware of it and poor quality never emerges, partly because consumers are taking a risk and on average some of them will lose and partly because there is an opportunity cost to the money that they spend on higher quality but do not receive¹⁶.
- d) **Consumers don't update quality judgements.** Consumers could also base decisions on their initial experiences of a product and not adapt it. This will mean that they aren't very responsive to changes in quality levels over time and can provide businesses with incentives to reduce quality over time.¹⁷
- e) **Quality signals can be fuzzy.** Noise in the quality signal can mean that consumers might find it difficult to ascribe quality. For example, milk may taste sour because of a poor quality fridge or because the fridge door was accidentally left open.
- f) **Consumers can't predict the future fortunes of business.** The possibility that some businesses may cease trading, means that

¹⁵ Economists call this a credence good – See Darby, M and Karni, 1973. 'Free competition and the Optimal amount of fraud'. Journal of Law and Economics 16:67-88

¹⁶ Opportunity costs are that they could have spent the money on something else.

¹⁷ This suggests that businesses can have a greater incentive to cheat on quality later in the product life.

consumers who pay for something up front but do not receive it until later may not be guaranteed they will get the product at all, not getting the product is deemed here as (ultimate) low quality. For example, consumers investing in a holiday would find it impossible to know for certain if the travel business they are about to commit to and pay upfront to will still be in business by the time they take their trip.

MARKET CONSEQUENCES

2.5 When consumers find it difficult to observe quality, the relationship between price and quality can break down. Consumer confidence can falter, as consumers understand that because they cannot judge quality, businesses could have incentives to misrepresent the quality they provide. Consumers who can no longer trust that price broadly signals quality may be reluctant to pay a higher price for products that claim to be higher quality. This in turn can drive higher quality out of the market even though some consumers would like to buy higher quality if they could trust it would be given. There are two similar but distinct economic drivers for this loss in consumer confidence, these are referred to as 'moral hazard' and 'adverse selection' or collectively as asymmetric information.

MORAL HAZARD – THE RISK THAT BUSINESSES CUT QUALITY

2.6 'Moral hazard' can occur where businesses can control the quality they provide. If consumers can observe only a quality promise from businesses rather than actual quality, businesses have an incentive to offer high quality but deliver low quality. Businesses have this incentive because there are no price consequences of cutting quality, consumers unaware of the lower quality, will not pay less, and thus as long as lower quality is cheaper to provide than higher quality, businesses will only produce low quality.

2.7 Rational consumers,¹⁸ however, will understand that a business has an incentive to lie about a high quality offer and only provide low quality. As a result consumers will only believe low quality offers and only offer to pay low quality prices. Since only low quality will be purchased businesses again have only the incentive to produce low quality. At the extreme high quality in the market will disappear.¹⁹ In general average quality will be less than consumers would like. An illustration is provided in box 2.2.

Box:2.2: Moral hazard

Imagine a business has the choice between offering broadband at £30 a month with high quality aftercare (easy to move house, 24 hour help line etc) or offering £15 a month broadband, with (assumed) low quality aftercare. The broadband service with high quality aftercare costs £10 to provide and with the low quality, £5 to provide.

The profit maximising option for the business is to offer high quality and make £20. But now imagine that when the consumer makes the purchase they cannot observe the quality level of the aftercare service, in this case because they will only experience the aftercare services after they are locked into a contract. Businesses have an incentive to offer a high quality after care but provide low quality and make instead £25 profit.

Consumers realise that businesses have an incentive to provide low quality even if they promise high and at the extreme no consumer will demand high quality.

¹⁸ Rational expectations are defined as 'An approach that assumes that people optimally use all available information (including information about current and future policies to predict the future)'. Mankiw (2000) 'Macro Economics' – fourth edition, Worth publishers.

¹⁹ In more complicated markets where consumers can learn there may be equilibriums in which both high and low quality exist. See Tirole – 'The theory of industrial organisation' – The MIT press.

ADVERSE SELECTION – THE RISK THAT GOOD BUSINESSES AND PRODUCTS GET DRIVEN OUT OF THE MARKET

- 2.8 The second problem, 'adverse selection' is again concerned with consumer's inability to observe quality. In this case, consumers know that products have varying quality levels, and they also know the probability that they will get products of different quality levels but they cannot tell which product is high quality and which is low. Unlike in 'moral hazard,' in this case businesses are not able to control the quality of the goods they produce, they can only decide whether to provide the good or not.
- 2.9 Under adverse selection consumers cannot simply offer to pay a higher price for a good car and a lower price for a bad car because they know that suppliers of bad cars would attempt to pass themselves off as good and get the higher price. Instead consumers, who cannot be sure of the quality, will offer an average price somewhere between the price they would be willing to pay for high quality and the price they would be willing to pay for low quality.²⁰ If however, this average offer price falls below a certain level sellers of high quality products may withdraw them from the market. The more high quality sellers that withdraw the lower the price offers becomes, as consumers know that there is an even greater chance they will receive lower quality.
- 2.10 The result is that the bad drive out the good and this continues until either the market has collapsed entirely, or only low quality exists (because higher quality producers have left). In either case average quality will be lower than is optimal. An illustration is provided in **box 2.3**.

²⁰ This assumes that an equilibrium where there is only low quality has not been reached. If this were the case only low price would be offered.

Box: 2.3 - Adverse selection²¹

The classic example, of this is the used car markets²². Imagine a consumer values the best cars on a car lot at £2400 and the worst cars on the lot at £1200. Imagine also that a seller would be willing to sell the best cars for £2000 and the worst for £1000. If consumers could observe quality there would be no problem. The best cars would sell at between £2000 and £2400 and worst cars would sell at between £1000 and £1200. However, if a consumer can't tell between best and worst cars they will have to guess how much each car is worth. They cannot offer £2400 because they know that there is a probability that it would be worth only £1200 to them. They will offer some 'shaded' price based on the expected value of the car they will receive, but at this 'shaded' price some sellers of higher quality cars may not be willing to trade. With fewer or none of the best cars in the market consumers will shade the price they offer even further (as the probability they have of getting the worst car has increased) and this will more sellers out of the market etc.

For instance assuming that there are only these two types of cars and the chance of getting the best or the worst is 50% the consumer will offer £1800²³. At this price the sellers of the best cars would not be willing to accept and will drop out of the market. At the extreme the bad can drive the good out of the market until only low quality exists.

²¹ Adapted from Varian: Intermediate microeconomics - A modern approach 5th edition (1999), Norton.

²² Akerlof (1970) 'The Market for Lemons: Quantity Uncertainty and the Market Mechanism' – The Quarterly Journal of Economics, Vol. 84 (August 1970) 488-500.

²³ Assume of course that this is before any equilibrium of only low quality existing is reached.

CONSUMER CONSEQUENCES

- 2.11 Under both moral hazard and adverse selection higher quality can disappear from the market and this means that market demand is lowered. Overall welfare is reduced because both sellers of high quality goods and consumers who desire high quality goods would be better off if they could trade, but no market exists where it is possible for them to do so. Average quality is lower than is socially optimal and welfare would be improved if average quality was increased.
- 2.12 Consumers may suffer detriment because there is no high quality in the market or if they are caught out and pay for high quality but receive low. Consumers might be stung if they decide to take a risk on quality and lose²⁴. For example, base the price they are willing to pay for a used car on the expected outcome (somewhere between the price they would pay for high and low quality), but they get the lowest quality and thus pay above the odds.

²⁴ This could be due to a calculated risk or naivety about the incentives the firm has to cheat.

3 INDEPENDENT MARKET-BASED SOLUTIONS AND CONSUMER LAW

- 3.1 Even where there are problems in a market, due to the effects described in the previous section, there will often be potential for independent market-based solutions. In addition, general consumer law can play a role in solving such problems. This means that there may be little need for, or benefit from, self-regulation. However, independent market-based solutions and consumer law can have limitations and in such circumstances self-regulation might be beneficial, (discussed in section four).

INDEPENDENT MARKET-BASED SOLUTIONS

- 3.2 Both individual businesses and consumers have strong incentives to find solutions to the quality problems described in section two. Businesses do so because otherwise they miss out on potential profits from selling higher quality products. Consumers do so because they want to be able to buy high quality and they don't want to get stung paying for high quality but receiving low quality. Market mechanisms respond to these incentives and can provide powerful ways for businesses and consumers to solve quality problems independently²⁵.
- 3.3 Independent market-based solutions seek to resolve problems of observing quality by helping to offer better quality signals to consumers, or by providing businesses with stronger incentives not to lie about quality.
- 3.4 These independent market-based solutions can take many forms. One form is the wealth of expert advice provided to consumers who want to

²⁵ A general discussion of how competitive pressures can act to protect consumers can be found in chapter two of a report prepared by Mark Armstrong for the OFT 'Interactions between competition and consumer policy – Economic discussion paper' April 2008. OFT991

make more informed decision based on quality. Information is provided by the market in two ways²⁶.

- a) First, the sellers themselves will seek to provide information about their product and where allowed to do so also provide information about the claims of their rivals products/services²⁷. Advertising can be an important way to provide this information (especially because it can do so without consumers having to make search efforts). The role of advertising, for example, in helping consumer to identify energy efficient products was highlighted in the European Commission's decision regarding the CECED agreement on washing machines (see box 5.2) which stated that '*Advertising campaigns often stress energy performance, thereby differentiating products, in a context where environmentally friendly products attract more and more consumers*²⁸'.
- b) Second, third parties might provide information to consumers. For example, specialist magazines, websites and consumer organisations such as Which?, can help to inform consumers of quality. The growth in the internet has been particularly influential in expanding the ability of consumers to get advice about quality.

²⁶ Mark Armstrong's paper discusses situations where there are incentives to disclose. For instance, a basic model in which a seller of high quality will want to reveal their quality and a rational consumer will therefore assume that all businesses who do not disclose quality information are low quality leading some theoretical models to conclude that all sellers wanting to disclose information. Similarly, consumers can follow the rule of thumb that those that advertise more heavily are likely to be better or cheaper than their rivals, so it might often be in the interest of better suppliers to advertise more. More details can be found in Mark Armstrong 'Interactions between competition and consumer policy – Economic discussion paper' April 2008. OFT991

²⁷ Ultimately this information must be verifiable to have value.

²⁸ Commission Decision of 24 January 1999 (Case IV.F.1/36.718. CECED)

- 3.5 Aside from the provision of information unilaterally suppliers can also solve problems of asymmetric information by offering warranties, guarantees and redress schemes to consumers who want to make sure they are not out of pocket if the product is faulty or they are otherwise dissatisfied. These reassure the consumer of quality because they know that businesses face a reduced incentive to lie about quality if they must replace or refund if quality promises are not met²⁹. They also in turn give suppliers an incentive to maintain high quality, since it can be costly to provide redress or honour guarantees. A good example of an independent market-based quality reassurance are high street stores which have returns policy that exceeds the requirements of consumer law.
- 3.6 The market also allows suppliers to offer deposit protection insurance to consumers who want to make sure that they are not out of pocket if businesses go bust. Deposit protection mitigates the risks consumers face when paying money upfront to a business, without being able to judge whether it will go bust. For instance, some warranties are based on insurance and these will typically also cover consumers if the product breaks but the business has ceased trading³⁰.
- 3.7 Perhaps the most important way the market can solve quality problems, however, is by enabling businesses to build reputation. Consumers who have good experiences can start to trust future quality promises from businesses and will reward them with repeat purchases or passing on 'word of mouth' recommendations. Meanwhile consumers who are unhappy with their purchase, because quality is lower than expected, will be able to punish the business by refusing to purchase from them again³¹ or by warning others. The potential for reputation to protect

²⁹ Or that only those with high enough fixed quality will be attracted to providing them

³⁰ Although both warranties and deposit protection can have disadvantages particularly if sold inappropriately.

³¹ This works better if consumers have the chance to learn (repeat experiences) and good memories. It seems intuitive that it will be harder to build up good reputation if goods or

consumers is widely acknowledged, for instance the economist Mark Armstrong suggests that '*...reputation (generally conceived) is a powerful force to constrain businesses to behave well, even when they supply highly complicated products*³².

- 3.8 Reputation will work to incentivise quality only where businesses wish to stay in the market for a sustained period of time and where consumers make repeat purchases themselves or are able to affect the purchase decisions of others, for example through 'word of mouth' recommendations.
- 3.9 For businesses interested in longevity, the loss in future sales from lying about quality can be greater than the short term benefits of providing lower than promised quality. Consumers understand that the desire for longevity means businesses have reduced incentives to lie about quality and their confidence in trusting quality promises will be restored. Often advertising is a good signal of this desire for longevity, because investing money upfront in branding and advertising would not be rational for a fly-by-night business interested only in being in operation for a short time. (The role of advertising in providing information was discussed above).
- 3.10 There is another form of quality problem which independent market-based solutions might be able to solve. Imagine there is a market where two retailers sell the same good from a wholesaler but they can choose how much to invest in the quality of the service. For example, they can choose to provide display boxes and well informed service staff, or not. If the retailers choose to provide lower quality service they will face lower costs and be able to charge lower prices. If the products being

services are infrequently purchased because consumer will have more chance to forget which businesses received bad 'word of mouth' when they make their decision and consumers who suffer have little chance to directly punish businesses.

³² Mark Armstrong 'Interactions between competition and consumer policy – Economic discussion paper' April 2008. OFT991

sold by retailers are identical, other than service, and consumers are able to move fairly easily between shops, all retailers might elect not to provide high quality service. Retailers will choose low quality because they fear that they will exert effort and therefore raise price only to have consumers make the final purchase in the low price shop next door, where quality service was not provided.

- 3.11 In this case it is in the wholesaler and not the retailer who has the right incentives to solve quality problems and as such wholesalers might be able to impose solutions on retailers. Wholesalers would benefit if retailers made extra service efforts (as there would be more total sales) and they have a unilateral incentive to get retailers to exert effort, thus generally wholesalers seek market solutions. These solutions might include for example, setting standards which all retailers have to meet.

LIMITATIONS OF MARKET BASED SOLUTIONS.

- 3.12 These market based solutions, however, have limitations. Costs incurred might be too high to make such solutions viable. For example, costly advice and advisors or high search costs could mean it isn't worth consumers investing in assessing quality levels.
- 3.13 Reputation can be difficult to develop. In particular reputation might be difficult to build if: consumers find quality is difficult to judge even after they have experienced the product; if goods and services are infrequently purchased; if there is limited scope for repeat purchase or 'word of mouth' recommendations; if there is a long time lag before quality is realised; or if the signal of quality is noisy (for example, consumers are not sure if home repairs that go wrong are due to poor workmanship or just bad luck). Costly advertising and branding could also create supply side barriers to building reputation, especially for smaller suppliers.
- 3.14 Another reason independent market-based solutions might fail is if consumers don't make decisions based on solutions offered by businesses (for example, they do not consider whether businesses have redress schemes). As Mark Armstrong puts it '*while the market may*

provide market information, it cannot force consumers to undertake market research'. Similarly, there are behavioural reasons why consumers might not respond to quality information as expected. Consumers who exhibit bounded rationality might make 'imperfect' quality decisions, even with full information, sometimes simply because of inertia. Further, they could find that more information confuses rather than clarifies quality signals³³. Moreover, sometimes consumers simply don't trust market solutions, for example they don't believe warranties will allow them to get a refund.

- 3.15 Independent market-based solutions may also be undermined by coordination problems. Businesses might face a kind of prisoner's dilemma³⁴ in acting unilaterally. While it can be in the industry's interest to resolve quality problems, so that more consumers are confident to pay higher prices and to enter the market. It is sometimes not in the interest of individual businesses to do so. Each individual business instead of improving quality may instead wish to free ride on the efforts of others.
- 3.16 The free rider problem arises because consumers who are unable to observe quality judge the industry as a whole rather than behaviour of individual providers. When businesses know that they will not be judged on their quality alone but on the quality of all businesses in the market they have an incentive to try and free ride on the high quality of others, and less incentive to rectify poor quality problems because they will not be fully punished for them.³⁵

³³ Better Regulation Executive and National Consumer Council (November 2007) - 'Warning! Too much information can harm' (URN 07/1553)

³⁴ Prisoner's dilemma – 'a situation in which two players each have two options whose outcomes depends crucially on the other's simultaneous choice, exemplified by two prisoners separately deciding whether to confess to a crime'. Concise Oxford English dictionary.

³⁵ For example, King and Lenox show that polls conducted by US chemical companies found that people do not distinguish between individual companies and the chemical industry as a whole. In particular, a few well-publicised chemical accidents have reduced the reputation of

- 3.17 For instance, in a car market characterised by adverse selection (illustrated in **box 2.3**) imagine one seller decides to sell only good cars. More good cars on the market help to increase consumer's confidence and willingness to pay, because the probability of getting a good car increases. However, because consumers can't tell the good from the bad all sellers will benefit from this not just the seller of the good cars. Each individual seller's incentive to provide good quality is therefore undermined.
- 3.18 Overall, despite strong incentives, businesses might not always be able to solve quality problems. Inability to build reputation, costs of providing solutions and free rider problems might all lead to the break down of effective independent market-based solutions. Small businesses especially might find that costs of advertising and branding are too high and that they lack the ability to create a strong enough reputation to allow consumers to trust their quality promise.

CONSUMER LAW SOLUTIONS

- 3.19 Consumer law also attempts to solve quality problems and like independent market-based solutions does so by; helping to offer better quality signals to consumers, or providing businesses with stronger incentives not to lie about quality. Consumer law can also help by overcoming limitations in the ability of individual consumers to monitor quality by monitoring and policing quality for them. Consumer law provides general solutions to quality problems because, for example:
- a) **legislation can ban or outlaw practices**, so that extremely low quality is removed from the market. For example Schedule 1 of the Consumer Protection from Unfair Trading Regulations (2008)³⁶ prohibits commercial practices which are unfair in all

the whole industry. 'Industry self-regulation without sanctions: the chemical industry responsible care program'. King and Lenox (Forthcoming in the 'Academy of management journal')

³⁶ OFT1008 - OFT/BERR CPRs guidance.

circumstances, such as falsely claiming that a 'product is able to cure illnesses, dysfunction or malformations', or claiming that 'products are able to facilitate winning in games of chance.'³⁷

- b) **licences can be required for traders** and then granted only to those who will meet the minimum required standard (positive licensing, for example, Credit licensing under the Consumer Credit Act 1974) or removed from those who do not meet the required standard (negative licensing, for example, under the Estate Agents Act 1979).
- c) Consumer law requires that **businesses provide what they say they are providing**. For example, the Consumer Protection from Unfair Trading Regulations 2008 prohibits traders from using unfair commercial practices, such as giving false information, or omitting material information, that either do, or are likely to, cause the average consumer to take a transactional decision he would not have taken otherwise. Meanwhile, under the Sale of Goods Act 1979 traders must sell goods that are as described and of 'satisfactory quality'³⁸. Similarly supply of services legislation implies that services must be carried out with 'reasonable care and skill'.
- d) more specifically it is a requirement resulting from the CPRs that **advertising does not mislead consumers**³⁹. An advertisement can be

³⁷ OFT1008 - OFT/BERR CPRs guidance.

³⁸ The Sale of Goods Act has been amended by the Sale and Supply of Goods to Consumers Regulations 2002 which transpose a European Directive and deal principally with consumer remedies. Source BERR - <http://www.berr.gov.uk/whatwedo/consumers/buying-selling/sale-supply/sale-of-good-act/page8600.html>

³⁹ Before considering complaints under CPRs, the OFT will normally need to be satisfied that the issues should not be resolved by using 'established means' such as by referral to the Advertising Standards Authority or the appropriate Trading Standards Service. Under the CPRs misleading advertisements might be a criminal offence and in addition the OFT may seek a court order to

misleading if, for example, it contains a false statement of fact, promises to do something with no intention of carrying it out or creates a false impression (for instance by leaving out important facts)⁴⁰. For example, the OFT have recently (November 2008) taken an injunction against racing tipsters for misleading advertising.⁴¹

- e) The Consumer Protection from Unfair Trading Regulations 2008 also **protects consumers against businesses passing themselves off as a rival business**. It is a commercial practice deemed unfair in all circumstances to promote '*a product similar to a product made by a particular manufacturer in such a manner as deliberately to mislead the consumer into believing that the product is made by*

prevent the publication of misleading advertisements. (adapted from 'Internet Shopping an OFT Market Study – June 2007'. OFT921.

http://www.offt.gov.uk/shared_offt/reports/consumer_protection/oft921.pdf?bcsi_scan_A2018E0826464712=0&bcsi_scan_filename=oft921.pdf

⁴⁰ Taken from 'Internet Shopping an OFT Market Study – June 2007'. OFT921.

http://www.offt.gov.uk/shared_offt/reports/consumer_protection/oft921.pdf?bcsi_scan_A2018E0826464712=0&bcsi_scan_filename=oft921.pdf

⁴¹ The OFT considered the mailings to be misleading as they gave the impression that the supposed 'experts' behind D&E Associates, 'Peter Deegan' and 'Christopher Emmerson', were real people with over 60 years combined experience in the horse racing industry and access to inside information. It was claimed that Peter Deegan 'had been involved with horse racing for nearly 40 years', and had worked as a 'private handicapper for the biggest punter/owner in the UK', while Christopher Emmerson was 'extremely well known within the racing fraternity' and knew 'all the horses in training in the UK'. In fact, there was no evidence that either person actually existed. This was enforced under the Enterprise Act 2002 (in relation to compliance with the Control of Misleading Advertisements Regulations 1988). The Consumer Protection from Unfair Trading Regulations (CPRs) came into force on 26 May 2008 and replaced a number of pieces of UK legislation, including the CMARs. However, Regulation 30(2) and Schedule 3 paragraphs 11 to 14 of the CPRs mean the OFT can still take enforcement action under the EA for domestic and Community infringements occurring before 26 May 2008, notwithstanding the repeal of those consumer protection laws.

that same manufacturer when it is not' . This protects businesses' ability to build reputation

- f) Finally, it can be a requirement in consumer law for some industries to provide **protection for consumers when they pay for a good or service upfront**. For instance⁴², the Package Travel directive requires suppliers to provide consumer remedies in the event of failure to deliver and compulsory refund and repatriation in the event of insolvency.⁴³

3.20 Businesses who fail to meet minimum quality standards or mislead on quality may then be punished by consumer law. For example, consumers can take court proceedings to seek damages from traders who do not exercise reasonable care and skill when providing services. While consumers who discover that products are not as described or are not of a satisfactory quality can reject them and ask for their money back, providing they do so quickly. Alternatively, in some circumstances they can request a repair or replacement or claim compensation.

3.21 Finally, following a breach of consumer law, enforcers, such as the OFT and Local Authority Trading Standards Services, may seek undertakings or, in appropriate cases, obtain enforcement orders. If an enforcement order is not complied with, this could be contempt of court resulting in a fine or imprisonment. Enforcers might also help deter businesses from cheating and/or protect consumers through publicising detail of

⁴² This was implemented by the Package Travel, Package Holidays and Package Tours Regulation.

⁴³ 'The organizer and/or retailer party to the contract shall provide sufficient evidence of security for the refund of money paid over and for the repatriation of the consumer in the event of insolvency'.

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31990L0314:EN:NOT>

undertakings that have been obtained or educating consumers. The OFT work on Scams awareness is a good example of education⁴⁴.

- 3.22 Consumer law helps consumer confidence in two ways. First, consumers know that it will deter businesses from lying about quality as they will be breaking the law and risk being punished for doing so. Second, consumers know they if they are cheated they have some opportunity for redress through the courts, if necessary.

CONSUMER LAW MAY NOT BE THE MOST EFFICIENT INSTRUMENT

- 3.23 If consumer law associated enforcement mechanisms were able to function perfectly and without cost, then businesses would not have incentives to lie about quality because they would always be found out and sufficiently punished.
- 3.24 In practice, consumer law and its enforcers have limited resources and ability to monitor all aspects of quality in all markets. Monitoring and enforcing is costly and enforcers need to prioritise, and will not be able to tackle every case that comes to light. Similarly, consumer law will not always prioritise tailoring enforcement to meet the requirements of individual industries or specific problems within individual industries.
- 3.25 Consumer law is also limited to enforcing what is within its scope. It generally does not promote quality which goes beyond legal standards or pursue anything other than the letter of the law.

⁴⁴ The Scamnesty campaign took place as part of the OFT Scams Awareness month over three weeks in February 2008. The nationwide campaign involved nearly 50 local authority trading standards services. The campaign will be run again by the OFT and Local Authority Trading Standards Services in February 2009. <http://www.of.gov.uk/news/press/2008/17-08>

4 SELF-REGULATION AS A SOLUTION

- 4.1 The previous section described how both general consumer law and market-based mechanisms offer potential solutions to the quality problems (identified in section two), but it also highlighted that they may not be the best instrument. This section describes how self-regulation can play a key role in overcoming these limitations.

SELF-REGULATION CAN OVERCOME QUALITY PROBLEMS

- 4.2 Self-regulation schemes typically involve groups of businesses committing to provide a certain quality standard via, for example, a code of conduct. These schemes 'regulate' member businesses to make sure that they all meet the quality standards which are set and/or that no member lies about the quality that they will provide.
- 4.3 In doing the above, self-regulation can help to remove problems with observing quality (outlined in section two) using similar principles to independent market-based and consumer law solutions. It can do so by; helping to offer better quality signals to consumers, changing the incentives businesses have to lie about quality, or making it less important that consumers observe quality by monitoring it for them.
- 4.4 Schemes, however, may be a better instrument than consumer law or independent market-based solutions, in particular, if they are able to more easily or more effectively: go beyond what is legally required; tailor rules and guidance to specific industry problems; overcome free rider effects; allow businesses to share costs of redress and reputation building; and rely less than independent market-based solutions on the actions of individual consumers and businesses.

SELF-REGULATION IMPROVING ON CONSUMER LAW

- 4.5 Self-regulation can improve on the functioning of consumer law by defining quality levels, helping to make quality more observable, resolving problems when rules on quality are not met (i.e. providing advice, sanctions and redress), and increasing the likelihood of

businesses getting caught cheating. Sometimes in performing these functions self-regulation schemes go beyond legal compliance.

DEFINING QUALITY LEVELS

- 4.6 Self-regulation schemes can define quality levels, for example, by:
- a) **Setting standards** - I.e. set out minimum standards needed to operate in the scheme;
 - b) **Issuing codes of practice or codes of conduct;**
 - c) **issuing licences accreditation or certification needed to operate in the market;** and/or
 - d) **issuing guidance** - Guidance provided by a scheme can help to define quality levels (more informally) by outlining best practice and identifying unacceptable practices.
- 4.7 Self-regulation schemes can often more effectively define quality levels and set standards than consumer law; in particular, because they can focus and tailor rules to a specific industry or issue found within that industry and they can update rules more quickly to respond to market changes.
- 4.8 Self-regulation can also offer an advantage because they can set quality standards above the level which would be stipulated in consumer law, and pursue the spirit rather than the letter of the law.

MAKING QUALITY MORE OBSERVABLE

- 4.9 Schemes can also offer benefits by providing additional mechanisms and resources to help consumers identify these quality levels. For example by:
- a. providing publicity to businesses by, for example, providing **consumer signposting** (logos and symbols), particularly useful to those businesses which find reputation difficult to build alone; and/or

- b. stipulating **transparency** and publicising quality commitments i.e. publicising the qualifications that a professional must have, making codes of practice publicly available, or making transparent **registration** a requirement

RESOLVING PROBLEMS WHEN RULES ON QUALITY ARE NOT MET (ADVICE, SANCTIONS AND REDRESS)

4.10 Once quality is defined schemes can resolve problems when rules on quality are not met (and thereby promote the standards set). They can do so by providing advice, sanctions, and/or redress mechanisms.

ADVICE

4.11 Often one effective way to promote standards is to provide advice to businesses to help them comply with legal standards, scheme stipulated standards, or industry best practice. Self-regulation schemes can often be best placed to advise businesses because they can focus and tailor advice to specific industry problems something it can be more difficult for legal enforcers, without the better information of businesses, to do. They can also invest more time, effort and resource in providing advice than legal enforcers.

4.12 Self-regulation schemes might for example, help aid compliance by clarifying the law to businesses, by reminding firms of best practice, or by provide training. Guidance and clarity can help to resolve quality issues that are a result of inexperience or ignorance.

4.13 Self-regulation may also be able to secure higher levels of voluntary compliance by businesses, due to an increased sense of ownership (derived from control over the generation of the rules) driving a willingness to comply.

SANCTIONS AND REDRESS

- 4.14 Other ways to promote standards are to provide sanctions against those who break them and to allow for redress mechanisms to compensate those who have been cheated. As discussed in section three, general consumer law provides sanctions for lying about quality (for example, enforcement orders that result in fines or imprisonment) and in some instances it provides consumer redress through the courts. However, those seeking to bring about compliance either via public or private means often have limited resources.
- 4.15 Self-regulation schemes can help to solve these problems and increase the strength of existing legal sanctions and redress. For instance, schemes can help navigate consumers through the existing systems and raise consumer awareness of rights (i.e. by providing guidance material). Schemes can also provide additional redress mechanisms which can also take out some of the risk, cost or efforts faced by an individual consumer.⁴⁵
- 4.16 Self-regulation schemes can also exert effort and resources to sanction businesses that lie about quality. Sanctions that self-regulation schemes provide commonly include; warnings, fines, naming and shaming (which can attract adverse publicity and so increase reputational damage). These sanctions can build on sanctions already in the legal system (consumer law) and can have an additional benefit because they can be flexible and be adapted to individual markets.
- 4.17 Self-regulation also has the ultimate sanction of being able to exclude a member (even though they may still be legally allowed to trade). Cost of exclusion can be made higher if self-regulation schemes require that businesses pay bonds or have insurance which they forfeit if they fail to meet quality commitments, or in voluntary schemes if the benefits from consumer sales of being in the self-regulation schemes are high.

⁴⁵ These redress schemes may function outside the legal system (but a consumer's existing legal rights continue to offer fall back protection).

INCREASE THE LIKELIHOOD OF GETTING CAUGHT

- 4.18 The greater the likelihood of businesses getting caught lying about quality levels and the faster the speed of detection the less attractive the cheating will be to businesses.
- 4.19 Self-regulation schemes can help increase the likelihood a business will get caught lying about quality, because they can increase the effort and resources on detecting and monitoring quality issues. They can also prioritise where consumer enforcers would not and in some cases go beyond even what a more resourced consumer enforcement agency might see as its remit.
- 4.20 Schemes could monitor more proactively, by running consumer complaint mechanisms, by performing mystery shopping exercises, or by more rigorously checking and requiring businesses to provide proof of quality, such as copies of terms and conditions, qualification certificates.

RELY LESS THAN INDEPENDENT MARKET-BASED SOLUTIONS ON INDIVIDUAL CONSUMERS OR BUSINESSES

- 4.21 Schemes can rely less than independent market-based solutions on individual consumers or businesses this may make incentives not to lie about quality more effective.
- 4.22 For instance, redress schemes provided by self-regulation schemes could be more effective than those independently provided by businesses. This could be because collective provision allows costs to be shared; adjudication could be less likely to be at risk of bias; and redress may still be available to consumers if an individual business ceases to trade. Although these advantages are counter balanced against the risks that scheme redress mechanisms could be more difficult to hold to account and could lack impartiality, (risks which are heighten when businesses and consumer interests are not aligned).
- 4.23 Liberation from reliance on individual consumers can also make self-regulation schemes more effective than independent market-based solutions. For instance if a consumer wishes to punish a business for

lying about quality they represent only one future sale (and word-of-mouth). Thus they have a limited ability to punish the business via its reputation. In contrast schemes have greater ability to punish and shame cheaters because they can reach out to and influence the decisions of more consumers.

- 4.24 Similarly schemes might also be better able to monitor quality because as outlined above monitoring can be more effectively done by a scheme than by an individual consumer. Although in some circumstances, for example, where it is very difficult to judge quality even after experiencing the product then self regulators, like consumers, might find quality harder to monitor.

SELF-REGULATION CAN SOLVE THE FREE RIDER EFFECT

- 4.25 Section three showed that sometimes independent market-based solutions might fail because of free rider problems. Self-regulation can succeed in resolving free rider problems by allowing for coordination between businesses. Coordination between businesses can prevent free riding on the reputation or on the quality efforts of another business and thus resolve the prisoner's dilemma that individual businesses face.
- 4.26 Collective initiatives allow for individual businesses to gain the full rewards for their quality efforts if all members are committed to provide a certain minimum quality and so no member can go below that and free ride on the others. For instance, if all sellers on a used car lot commit not to sell low quality cars, (and it is effective) then no seller will be able to sell their low quality cars at that used car lot and so no low quality provider will be able to free ride on the good quality of others. (See **box 2.3**).
- 4.27 Across the industry the free rider problem is resolved as either a) everyone in the market is a member of the scheme (if self regulation is compulsory) and thus no one has the opportunity to free ride; or b) when coverage is not complete (when schemes are voluntary) free riding can be solved because businesses are better able to build reputation as consumers learn that that there is a different quality signal from scheme

members to non-scheme members. This provides incentives for businesses to join schemes and means that non members will not be able to free ride on member's efforts to ensure quality. There will no longer be an incentive for members to under invest in quality.

SELF-REGULATION CAN ALLOW BUSINESSES TO SHARE COSTS

4.28 The collective nature of self-regulation can allow self-regulatory schemes to succeed where individual efforts fail because it can be more efficient, particularly for smaller businesses, to share the costs of building reputation (advertising and branding) and of providing redress schemes.

OVERARCHING SELF-REGULATION REQUIREMENTS

4.29 In practice there are many principles that could provide guidance to generating successful self-regulation outcomes. This section does not drill down into operational or policy criteria, but it sets out three important overarching requirements for self-regulation schemes. First, **businesses that sign up must meet the standard set**. This means that schemes need to be able to monitor and judge quality and sanction bad behaviour. It is for these reasons, for example, that OFT Consumer Codes Approval Scheme (CCAS) outlined in **box 6.1** insists on compliance (for example Criterion 1b⁴⁶), an effective monitoring regime (for example Criterion 5a-5b and 5f⁴⁷) and timely disciplinary procedures and sanctions (for example, Criterion 6a-6b⁴⁸)⁴⁹.

⁴⁶1b - Codes shall include a provision that compliance with the code is mandatory. Code sponsors must be able to demonstrate that members are prepared to observe the code's provisions.

⁴⁷ 5a - The code sponsor shall develop performance indicators, e.g. mystery shopping exercises and independent compliance audits, to measure the effectiveness of the code. 5b - The code sponsor shall implement the performance indicators and make available the results of their monitoring procedures and satisfaction surveys to demonstrate the effectiveness of the code. 5f- Consumer satisfaction shall be regularly assessed.

⁴⁸ 6a- Code sponsors shall establish a procedure for handling non-compliance by members with the code. The procedure shall include independent disciplinary procedures and reasonable

- 4.30 Second, **self-regulation schemes need to have enough members/or the right membership to have an impact.** This is important both if the scheme is to have significant influence on the sector (actually improve consumer confidence in the area) and to ensure that there are adequate resources and funding needed to support compliance. This is the reasoning behind Criterion 1a and 1c in the CCAS scheme⁵⁰. This could be about a few progressive or influential businesses rather than force of numbers.
- 4.31 Individual businesses will join schemes if the profits made from membership are greater than the costs. One reason voluntary schemes will be profitable is if consumers have a preference for choosing to buy from a scheme member. If consumers do not have any preference for members, then businesses are unlikely to have an incentive to join. To generate such consumer preferences, it is important that consumers are made aware of what the scheme provides for them for example through publicising, branding and logos. It is for this reason that the CCAS scheme stresses the importance of consumer awareness (for example criteria 7a-7c⁵¹).
- 4.32 There are also possible benefits to membership other than increased sales due to consumer awareness. For example, it might be that the redress procedure built into the code is preferable from a business's

timescales for action. 6b - The code sponsor shall also set out a range of sanctions, e.g. warning letters, fines, termination of membership, for dealing with non-compliance.

⁴⁹ Criteria references taken from 'Consumer codes approval scheme core criteria and guidance March 2008 OFT390' http://www.offt.gov.uk/shared_offt/Approvedcodesofpractice/offt390.pdf

⁵⁰ 1a- Code sponsors should have a significant influence on the sector. 1c - Code sponsors shall have adequate resources and funding to ensure the objectives of the code are not compromised

⁵¹ 7a Code sponsors and members shall ensure that their customers are aware of the code. 7b Code members are to make clear, e.g. in advertising, point of sale, their adherence to a code of practice. 7c Copies of codes shall be available without charge to customers, to members, to local consumer advisers and to others with a legitimate interest.

perspective to potential legal action taken by the regulator. It might also be that there are other benefits of joining a scheme such as training, or networking opportunities which can aid to profitability and therefore work as a benefit of joining a scheme. When a scheme is made compulsory, such benefits are clear: you need to be a member to make any profit in the industry.

- 4.33 Third, **any benefits which are generated from self-regulation must not be negated by factors such as detriment to competition.** The risks to competition are discussed in section five.
- 4.34 Beneath these overarching principles there are potentially many operational and policy criteria (such as the ideal structure of a body, the type of redress, the role of stakeholders etc). These are not discussed further in this paper although discussions appear in the literature.⁵²

SELF-REGULATION RISKS FALSE QUALITY SIGNALS

- 4.35 One danger with self-regulation is that schemes fail to provide the quality that they say they will provide and offer only a false signal of quality. False signals of quality are dangerous because consumers can be 'mislead' into making inappropriate purchase decisions (and at the extreme buy faulty or unacceptable products). This may be particularly problematic where quality is never revealed or where problems in quality may take a long time to unravel. Worse still, false signals of quality from self-regulation schemes might be more convincing than lies from individual businesses and the detriment to consumers could then be exacerbated, rather than corrected by self-regulation. The CCAS described in section six will provide safeguards for schemes that go through the approval process. Otherwise, the prohibitions on unfair commercial practices in the Consumer Protection from Unfair Trading

⁵² For example, see Ofcom – 'Initial assessments of when to adopt self- or co-regulation consultation' March 2008 or National Consumer Council 'Models of self-regulation – An overview of models in business and the professions' November 2000.

Regulations 2008 (see for example box 6.5 and paragraph 3.19 of this paper) provide possible legal solutions.

- 4.36 Even a self-regulation scheme which provides the quality it purports to, could lead consumers into making inappropriate choices. This could happen if consumers misunderstand the quality that a self-regulation scheme provides. For instance, if a consumer thinks that a scheme provides broader levels of quality than it does or does not understand that some quality might be unnecessary or irrelevant to them⁵³. For example, a consumer who isn't a connoisseur of wine might get the same utility from organic and non organic wine. Choosing a more expensive wine from a self regulated organic wine company because they think quality is higher will be a misallocation of their resources. In such circumstances consumers could end up paying for higher quality, which they do not value and they could have saved money by shopping elsewhere.
- 4.37 Nonetheless when true and useful quality signals are provided effective self-regulation can play an important and beneficial role in allowing businesses to commit to providing products and services of a particular quality. Self-regulation also has the potential to enhance competition, if it enables more businesses to exist in the market and/or allows for greater competition on quality. In particular, self-regulation can make it easier for smaller businesses to compete, who could individually struggle to overcome the costs of committing to quality or find it harder to establish a reputation.

⁵³ Recall as in box 2.1 that quality can be seen as the utility experienced.

5 COMPETITION CONCERNS

- 5.1 As discussed in the previous section self-regulation can play an important and beneficial role in allowing businesses to commit to providing products and services of a particular quality. It also has the potential to enhance competition through doing so, if it enables more businesses to exist in the market and/or allows for greater competition on quality. In particular self-regulation can make it easier for smaller businesses to compete, who could individually struggle to overcome the costs of committing to quality or find it harder to establish a reputation.
- 5.2 But there can be risks to competition from self-regulation. While self-regulation can solve free rider problems and allow businesses to share costs (achieve economics of scale), it can also cause competition concerns.

COMPETITION RISKS

- 5.3 The risk that self-regulation can have an appreciably negative effect on competition is recognised by Chapter I of the Competition Act 1998 and Article 81 EC⁵⁴. These provisions prohibit agreements between undertakings, decisions by associations of undertakings or concerted practices which may affect trade (either within the UK or between EU Member States) and which have the object or effect of preventing, restricting or distorting competition, unless they meet certain exemption criteria.
- 5.4 Under the Competition Act and Article 81 EC, self-regulatory bodies are seen as being capable of breaching the competition rules if they make

⁵⁴ OFT guidance states that 'Self-regulating bodies are associations of undertakings and Article 81 and the Chapter I prohibition apply to their rules and decisions in exactly the same way as to those of any other association of undertakings.' OFT guidance – 'Trade associations, professionals and self-regulatory bodies: understanding competition law' Dec 2004. OFT408.

decisions⁵⁵ which influence or moderate behaviour by members on the market (even if these are non binding)⁵⁶ and if those decisions have the object or effect of preventing, restricting or distorting competition.

- 5.5 Aside from the decisions of self-regulatory bodies, competition concerns may also arise in relation to cooperation between the members of the self-regulation scheme if this has the object or effect of preventing, restricting or distorting competition.
- 5.6 One concern with self-regulation is that the probability of anti-competitive practices (such as price fixing or raising barriers to entry so that they are unnecessarily high) will be increased. Just as it can be in the collective interest of businesses to solve quality problems so can it be in the collective interest of businesses to restrict competition. In this way cooperation may spill over into areas which raise competition law concerns.⁵⁷
- 5.7 The process of self-regulation can open the door for businesses to restrict competition, either explicit collusion or tacit collusion. In reaching and enforcing agreements on quality, opportunity is provided for businesses, for example to; share information on demand costs and production processes; monitor each other behaviour on an on-going basis; or co-ordinate output decisions, and this could result in a

⁵⁵ Constitutions and rules of the body, recommendations to members, and resolutions or decision of the management body or executive body, all comprises 'decision' by an association.

⁵⁶ Although OFT guidance states that 'The agreements or conduct of some self-regulating bodies, notably those operating under the Financial Services and Markets Act 2000, are excluded from the Chapter I prohibition and Chapter II prohibition. In these cases, competition scrutiny of the self-regulating body's rules is already provided for under its own specific legislation'. OFT guidance – 'Trade associations, professionals and self-regulatory bodies: understanding competition law' Dec 2004. OFT408.

⁵⁷ The issues discussed in the following section are similar to and draw on the findings in 'Competition impact of environmental product standards – A report prepared by Frontier Economics for the OFT' (OFT1030).

restriction, distortion or prevention of competition. In other words, the agreement could have an anti-competitive intent or the process of coming to an agreement may facilitate coordination.

5.8 In addition, self-regulation agreements or decisions that regulate quality could themselves dampen competition (particularly by raising barriers to entry) if:

- a) **they have asymmetric impacts.** Minimum quality requirements set by a scheme might advantage some businesses over others (for example, it could be more costly for some businesses to meet standards). This could result in a lessening of competition, as fewer businesses can compete or entry is restricted. Consumers might expect higher prices if quality increases but asymmetric impacts could mean that consumers face prices which are higher than would have resulted from the increase in quality alone. There is also scope for asymmetric impacts if products are interpreted by consumers as having a quality level which isn't reflective of true quality (as discussed in paragraphs 4.35-4.36). False quality signals could have competition implications by giving scheme members an unfair competitive advantage at the expense of their rivals;

- b) **they result in quality levels which are too high.** Theory suggests that businesses might have an incentive to make quality higher than would be optimal for consumers. Intuitively, industry profits can be increased if output is restricted and this can be done by setting high quality standards.⁵⁸ If barriers to entry are created for lower quality providers or the agreements exclude lower quality products, consumers could suffer. Those who would like to buy

⁵⁸A discussion of why quality can be set too high can be found in 'H. Leland, 'Quacks, Lemons and Licensing: A Theory of Minimum Quality Standards' Journal of political Economy (1979)' or A Shaked, J Sutton – 'The self regulating professions' Review of Economic Studies', (1981).

lower quality can't do so, and competition is dampened as the range of quality competition narrows;

- c) **they result in businesses gravitating towards one quality.** Where a minimum quality standard is set businesses may gravitate towards providing the minimum quality. This reduces choice and again weakens quality competition. It also risks providing a focal point through which businesses could have an increased ability to collude.

- d) **they limit innovation.** If self-regulation schemes are prescriptive about how quality standards must be met then innovations that could have benefited consumers could be forgone, including those concerning the structure of business models or structures. For example, the OFT in its report on competition in professions argued that the prohibition on barristers forming partnerships with other barristers or members of other professions means that *'barristers' choices to adapt their business structures in the way that best meets their needs and those of the client is restricted'*,⁵⁹

- e) **they limit competition through conduct restrictions.** Restrictions on advertising can dampen competition because advertising is one mechanism through which businesses compete⁶⁰. (It is for this reason that the OFT sought for restrictions on prohibiting advertising fee comparisons and other forms of comparative advertising be addressed in the legal and accountancy

⁵⁹ 'Competition in professions – progress statement' April 2002. OFT385.

⁶⁰ The OFT competition in professions progress statements states: 'A simple prohibition on comparative advertising of services denies information to clients that would help them to choose a provider. It also restricts the ability of more efficient service providers to develop their services. A blanket prohibition on advertising services is likely to go beyond what may be necessary to protect consumers. In particular, we do not accept that prohibiting comparisons on elements such as price, where these are factual and verifiable, can be justified in the interests of consumers. This is an issue which OFT will pursue with the professional body in question, as with any professional body that maintains in force rules that may unnecessarily limit freedom to advertise'. 'Competition in professions – progress statement' April 2002. OFT385.

professions⁶¹.) Another way in which professional bodies can affect the conduct of their members and restrict competition is to issue recommendations as to appropriate price for service. **Box 5.1a** illustrates the outcome of the challenge by the OFT to a price recommendation issued by the Royal Institute of British Architects and which the OFT considered unnecessarily restricted competition on price between architects; or

- f) **they prevent inefficient businesses from failing.** Competition could also be dampened if schemes protect less efficient businesses from exiting the market. For, example, it could occur if due to membership of a self-regulation scheme inefficient businesses could benefit via their association with efficient ones.

5.9 **Box 5.1b** illustrates a judgement against a US self-regulatory scheme which was found to have restricted competition.

⁶¹ 'In its report Competition in professions' – March 2001 OFT328 the OFT identified rules of professional bodies in the professions law, accountancy and architecture that it considered unnecessarily restricted competition. The OFT called on the professional body responsible to justify or remove these restrictions. Many of the rules related to conduct (advertising restrictions and published price recommendations) and to business structure. In 'Competition in professions – progress statement' April 2002. OFT385 OFT noted that, in response to its report a number of such rules had been withdrawn by the professional body responsible. In other cases the OFT pursued a subsequent dialogue with the professional body towards ensuring that the rule was justified or withdrawn.

Box 5.1a - Royal Institute of British Architects – Competition case closed summaries - 2003.

The OFT report 'Competition in professions' and the subsequent progress statement called on RIBA to justify its fee guidance as benefiting consumers or to remove it.

RIBA sought to justify the existence of its fee guidance on the basis that it could not restrict competition because it was merely indicative and that it was a useful yardstick by which clients who may be ignorant of what a reasonable charge was could forecast the cost of architectural services.

The report indicated that the fee guidance issued by RIBA could facilitate collusion⁶². Circulation of guidance on fees issued by an association of undertakings or a professional body may encourage tacit collusion as it is likely to provide a lead on prices which may hinder the ability or incentive of efficient businesses to compete by reducing price to reflect their lower costs⁶³. It may also protect those who are less efficient and reduce the incentive to improve. The fact that the guidance was in the form of an indication rather than a binding decision did not prevent it from being a decision by an association of undertakings.

RIBA has amended and revised its fee guidance. New fee guidance is based on historical information and the collation of price trends which do not provide a lead on this year's prices. The historical information is collated and aggregated by an independent body. OFT considers that this change meets the competition concerns expressed in the report and progress statement and in subsequent correspondence with RIBA.

⁶² OFT considers that architects that are members of RIBA are likely to be undertakings within the terms of the Chapter I prohibition. RIBA is an association of these undertakings.

⁶³ The case closed summary highlights that this approach is apparent in a number of the European Commission and Court of Justice decisions e.g. *Verband der Sachversicherer e.V. v Commission*, Case C-45/85, point 26, *Case C-8/72 Vereniging van Cementhandelaren v Commission* [1972] ECR 977, [1973] CMLR 7, points 19-21, IV/34.983-FENEX.

Box 5.1b: NATIONAL SOCIETY OF PROFESSIONAL ENGINEERS V. UNITED STATES, 435 U. S. 679 (1978).⁶⁴

The United States brought a civil antitrust suit against the National Society of Professional Engineers, alleging that its canon, which prohibited its members from submitting competitive bids for engineering services, suppressed competition and was in violation of competition law.

The Court of Appeal held that *'The canon amounts to an agreement among competitors to refuse to discuss prices with potential customers until after negotiations have resulted in the initial selection of an engineer, and, while it is not price-fixing as such, it operates as an absolute ban on competitive bidding, applying with equal force to both complicated and simple projects and to both inexperienced and sophisticated customers.'*

The society of professional engineers argued that it was justified because it was adopted for the purpose of minimizing the risk that competition would produce inferior engineering work and endanger public safety.

The case resulted in the Court of Appeal prohibiting the society of professional engineers from adopting any official opinion, policy statement, or guideline stating or implying that competitive bidding is unethical.

MITIGATING COMPETITION EFFECTS

- 5.10 There might be some business which cannot compete effectively when minimum quality standards are set, because quality is above the level they currently produce and switching to a higher quality is costly. Initially this can limit competition as they will be excluded from the

⁶⁴ <http://supreme.justia.com/us/435/679/case.html> Sherman Act.

scheme. Over time, however, the business can learn how to lower costs and switch to high quality production⁶⁵. This can reduce the risk that competition will be damaged in long term. Whether the minimum quality standards will result in an appreciable adverse effect on competition in such circumstances will depend on the proportion of competition that is immediately restricted and the length of time that would be needed before the affected businesses can adapt. The longer the time necessary to adapt, the greater the effect on competition and the more likely that harm will result.

- 5.11 Mitigation could also occur if restrictions on aspects of competition can be partly alleviated by businesses responding through more vigorous price competition or competition on other aspects of the products⁶⁶ or if restrictions are less likely because schemes are not prescriptive as to quality level but simply stipulate that members must be honest about it.
- 5.12 Generally concerns over competition might be less where (a) the market is open and competitive or (b) there is limited chance of the self-regulation having an appreciable effect on competition. For instance, an appreciable effect on competition is less likely if the proportion of businesses involved in self-regulation on a given market is small or if only one aspect of quality competition is affected.

⁶⁵Similarly, adaption by businesses means that output may also not be restricted as a result of higher quality standards and the incentive to set the quality too high could also dissolve.

⁶⁶ For example the commission decision on domestic washing machines (see box xx) stated *'Indeed, the restriction in one product dimension, energy consumption, may increase competition on other product characteristics, including price. Therefore, while the minimum price of washing machines is likely to increase, it cannot be ruled out that products in categories A and B may become available at a lower price. In a market characterised by strong competition amongst manufacturers and bargaining power from distributors, these benefits are likely to accrue to consumers.'* Commission Decision of 24 January 1999 (Case IV.F.1/36.718. CECED)

POSSIBILITY FOR EXEMPTION FROM THE COMPETITION PROHIBITIONS

- 5.13 Some schemes may have the object of preventing, restricting or distorting competition (e.g. schemes that fix prices, share markets or limit output). Such schemes will be considered as always being likely to have an appreciable adverse effect on competition and are likely to fall foul of the prohibition (as they are unlikely to meet the criteria for exemption). Schemes that do not have such an object will have to be assessed to determine whether they are likely to have such an effect. This will depend on factors such as the proportion of the market covered by the scheme, whether the scheme is voluntary or mandatory, the requirements of the scheme, the market share of the companies who are party to the scheme, the structure of the market, and barriers to entry.
- 5.14 Consequently, when contemplating self-regulation, it will be important that the parties assess, if necessary by taking independent legal advice, whether self-regulation is likely to result in a prevention, restriction or distortion of competition within the meaning of the competition rules and, if so, whether the exemption criteria set out in the Competition Act and/or Article 81(3) EC are met.⁶⁷ An agreement will satisfy the criteria for exemption if it:
- a) contributes to:
 - i) Improving production or distribution, or
 - ii) Promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit; but
 - b) does not:

⁶⁷It is outside the scope of this paper to provide a full assessment of all relevant aspects of the competition law. We do not attempt to explain the law here; nor do we represent the OFT's view of what is permissible under UK and EU law. The assessment of whether self-regulation schemes meet the exemption criteria must be made on a case by case basis, following legal advice. The OFT provides more guidance in this area on its website.

- i) Impose on the undertakings concerned restrictions which are not indispensable to the attainment of those objectives; or
- ii) afford the undertakings concerned the possibility of eliminating competition in respect of a substantial part of the products in question⁶⁸.

5.15 These exemption criteria are cumulative, which means that in order to qualify for exemption, all of the criteria must be met. For example, it is not sufficient that a self-regulation agreement brings about an improvement in distribution if the resulting benefit is not passed on to consumers or if the efficiencies that give rise to that improvement could have been achieved through less restrictive means.

5.16 **Box 5.2** outlines a Commission decision in which restrictions on competition were present but the agreement nonetheless qualified for exemption.

⁶⁸Section 9 of the Competition Act 1998. See also OFT guidance – 'Trade associations, professionals and self-regulatory bodies: understanding competition law' Dec 2004. OFT408.

Box: 5.2 - Consumption of Domestic Washing Machines⁶⁹.

The Conseil Européen de la Construction d'Appareils Domestiques (CECED) members include manufacturers producing and selling a wide range of domestic appliances (under various brands in various Member States). It introduced its first Voluntary Commitment on Reducing Energy Consumption of Domestic Washing Machines in 1997. (The commitment expired in December 2001.)

The agreement targeted an average energy consumption of 0.24 kWh/kg (based on a standard washing profile) for each producer, weighted by the volumes of production. This was to be achieved by phasing out production and imports of washing machines in energy efficiency classes E-G, with a partial phase out for class D and strengthening other energy saving activity.

The agreement was investigated by the European Commission. The Commission found that *'the aspects of the agreement which prevented parties businesses producing or importing categories of washing machines under energy labels D to G has ...the object of restricting or distorting competition.... and that 'the agreement is likely to have an appreciable effect on competition and trade between Member States within the meaning of Article 81(1) of the EC Treaty and Article 53(1) of the EEA Agreement'*.

The Commission considered whether the agreement could be exempted under Article 81(3). The Commission's report found that:

- (i) the agreement contributed to economic or technical progress because the future operation of an installed base of machines which provides the same service with less indirect pollution is more economically efficient and that future research that would lead to increased product differentiation is likely;

⁶⁹ This example may fall outside the definition of self-regulation set out in this paper, because although there are some issues which might be of interest to consumer enforcers the primary objective can be seen as raising environmental standards which is outside of general consumer law. Nonetheless it is a good example of the application of the exemption criteria under Article 81(3) EC.

(ii) consumers would receive a fair share of the benefits.

(iii) the restrictions were indispensable, as the agreement did not impose an restrictions that were unrelated or unnecessary to the fulfilment of its objective benefits and no reasonable less restrictive alternatives to this agreement would be capable of delivering similar reductions in total electricity consumption;
and

(iv) the agreement would not eliminate competition, as the parties would continue to have a wide variety of technical choices on which to effectively compete.

Consequently the Commission found that the conditions of Article 81(3) were satisfied and the CECED agreement was exempted from Article 81(1) until 2001⁷⁰.

⁷⁰ Taken from Commission Decision of 24 January 1999 (Case IV.F.1/36.718. CECED) and 'Competition impact of environmental product standards – A report prepared by Frontier Economics for the OFT' (OFT1030).

6 INTERACTIONS BETWEEN EXTERNAL REGULATION AND SELF-REGULATION

- 6.1 While self-regulation is in this paper by definition a voluntary self-interest, external regulators and regulation can also play a role in helping schemes to deliver benefits. This section explains how external regulation can support self-regulation.
- 6.2 Section four discussed the possible benefits that self-regulation might have over independent market-based solutions or consumer enforcement and along with section five also highlighted some risks to self-regulation. This section builds on that analysis, discussing how self-regulation which works well may be a better instrument than, not just consumer enforcement but general external regulation, for achieving benefits and again highlights the risks of using self-regulation over external regulation.

WAYS THAT EXTERNAL REGULATION CAN SUPPORT SELF-REGULATION

- 6.3 External regulators can have an important role to play helping self-regulation to be as effective as possible and ensuring that any risks to self-regulation are minimised. **First, regulators can help increase scheme benefits.** A good example of this is through the credence offered via OFTs CCAS. The CCAS is discussed in Box 6.1.

Box: 6.1 - Consumer Codes Approval Scheme

The Consumer Codes Approval Scheme is an OFT-backed scheme that encourages self-regulation by giving official approval to voluntary consumer codes of practice which meet the core criteria set by the OFT. The code must be administered by a code sponsor capable of influencing and raising standards in its sector and the code itself must tackle consumer issues as appropriate to the sector, provide appropriate consumer redress mechanisms and commit the businesses to offering a higher level of customer service than is required by law. While participation in the scheme may involve some time and resources, the incentive for the businesses involved is the ability to distinguish themselves from other non-participating businesses in their sector. Evaluation of the Consumer Codes Approval Scheme to date shows that over half of current members of an OFT approved code believe that the benefits outweigh the costs and only three per cent said the burden was greater than the value⁷¹.

Businesses operating under an OFT approved code are licensed to use and display the OFT Approved code logo which is marketed to the public and, as more codes join the scheme, is increasingly been seen as a guarantee for high quality service and a brand that consumers will look for when making purchases of goods and services. The OFT Approved code logo provides consumers with a guarantee that the code has been rigorously checked and evaluated to ensure that it works in practice and delivers on its promises. The ability to distinguish themselves by use of the OFT Approved code logo provides a powerful marketing tool for participating business and gives them a competitive edge in their sector by developing best practice and helping them to attract and retain customers. While these codes do not directly lead to rogue traders being penalised or removed from the market, they can help to marginalize them by empowering consumers to avoid them.

6.4 Another way of increasing the benefits to a scheme is through altering incentives by threatening to act if the industry does not. This can alter

⁷¹ http://www.offt.gov.uk/shared_offt/Approvedcodesofpractice/oft870.pdf

the equation in favour of self-regulation in industries where the voluntary self-interest is not enough to outweigh the costs. The prospect of external regulation can provide strong incentives for industry to self-regulate because the cost of a scheme may be less than the cost of external regulation.

- 6.5 The power of a threat can be seen in the car servicing and repair code which has been developed by Motor Codes Ltd and is currently being assessed under the OFT's Consumer Codes Approval Scheme described in **Box 6.2**

BOX:6.2 - Motor Codes Ltd

In its 2005 report, *At a Crossroads: Getting the Car Servicing and Repair Sector Back on Track*, the then National Consumer Council (NCC) estimated that consumer detriment in the sector was in the region of £4 billion annually and identified a number of potential remedies to the problems encountered by consumers. However, they pulled back from recommending statutory regulation at this stage suggesting that the industry be first given an opportunity to raise standards through self-regulation. An industry wide working group has since then developed a consumer code to tackle the consumer problems identified, has established Motor Codes Ltd as a body able to administer the code on the industry's behalf (launched August 2008). If this voluntary code is successful, then the solution developed by the industry with the support of the OFT, the NCC and other consumer bodies will raise standards in the industry and provide consumers re-assurance and confidence in the marketplace without the need for more formal Government intervention.

- 6.6 In addition, regulators can go further than a threat and choose to compel self-regulation by making membership of a scheme compulsory and giving some industries a formalised and specific legal backstop. This makes benefits of joining even more stark as the alternative is to exit the industry. Good examples of compulsory self-regulation include the self-regulatory bodies in many of the professions which have statutory backing requiring them to operate.

- 6.7 When regulators do decide to intervene they might also decide to get more directly involved in how the schemes function and what they should contain. They might, for example, play a role in the set up, administration or enforcement or even specify what must be contained in the code.
- 6.8 When regulators engage to promote self-regulation in ways which go above and beyond the normal enforcement under consumer law it is likely to be resource intensive. Regulators might therefore be expected only to exert additional effort to promote self-regulation where it is likely to generate most benefit to consumers.
- 6.9 Circumstances in which regulators are more likely to encourage the industry to move towards self-regulation include:
- a) industries where quality is never revealed: in these industries independent market-based solutions may be less likely to resolve issues since reputation is harder to build;
 - b) industries where there are relatively more small suppliers: small businesses can find reputation harder to build and hence in these industries independent market-based solutions may be less likely to resolve issues;
 - c) when consumer detriment would be high even with appropriate levels of normal consumer law enforcement in the market; and
 - d) when there are checks and balances in place to mitigate against any risks to self-regulation: this ensures that benefits to consumers are more likely to be realised.
- 6.10 Although resource intensive upfront, engaging with self-regulation can save on enforcement costs later down the line. For this reason in some cases self-regulation schemes may be asked specifically to participate to help compliance with consumer enforcement law. Well-founded and effective system of achieving this compliance could be considered

'established means'.⁷² A good example of this is the ASA outline in box 6.3. The OFT has consulted on how to develop the use of its compliance partnerships or 'established means' under the Consumer Protection from Unfair Trading Regulations 2008 and the link here provides a fuller discussion⁷³.

http://www.offt.gov.uk/shared_offt/consultations/oft1043con.pdf

Box: 6.3 - Advertising Standards Authority.

The Advertising Standards Authority (ASA) is a self-regulatory body. It is recognised as the first port of call (or established means) for resolving complaints and non-compliance about advertisements across all media. In non-broadcast media (for example print, posters, cinema, direct marketing and paid for Internet advertisements) under the British Code of Advertising, Sales Promotion and Direct Marketing (the CAP Code). The CAP Code supplements the law, fills gaps where the law does not reach (for example on matters of decency) and often provides an easier way of resolving disputes than by civil litigation or criminal prosecution. The OFT will therefore generally refer complaints about misleading advertising to the ASA to deal with in the first instance.

If the ASA rules that an advertisement breaches one of the Codes, all parties are committed to enforcing the decision, including the media owners who can refuse space to further non-compliant advertisements. The ASA has a range of sanctions that it can apply and the statutory backstop is of course referral to the OFT under the CPRs.

⁷² Historically 'established means' have been bodies defined as such with a recognised role in helping to enforce legislation where they are seen as having a legitimate interest in securing compliance with the specified legislation

⁷³ Compliance partnerships: An OFT consultation on developing the use of 'established means'. December 2008. OFT1043con

- 6.11 Other compliance partnerships may develop on a more ad-hoc basis which including those with self-regulatory bodies. An example, of this is outlined in **box 6.4** which explains recent work by ABTA - The Travel Association and the OFT.

Box 6.4: ABTA- The Travel Association

The OFT became aware that holiday and travel suppliers were routinely excluding fixed, non-optional costs (such as taxes and fuel supplements) from advertised prices. Concerned that this was misleading for consumers and harmful to businesses that displayed fully inclusive prices, the OFT issued a warning to the holiday and travel industry to ensure it was not misleading consumers about prices. Following the warning the OFT also engaged with 13 airlines, based in the UK or elsewhere in the European Union, to ensure they changed the way prices were displayed on their websites.

In a co-ordinated move, ABTA agreed with the OFT that it would take action to ensure its members complied with the ABTA Code of Conduct, which requires them to include fixed, non-optional costs in advertised prices. Many ABTA members made changes to their websites in order to comply with the Code and ABTA handed out fines and reprimands to the few members that failed to comply. The OFT worked closely with ABTA on this matter and strongly welcomed and supported ABTA's actions. The action taken by both the OFT and ABTA has resulted in improved price transparency across the holiday and travel industry.

- 6.12 **Second, regulators can help self-regulation by proactively creating an environment which allows genuine schemes to flourish**, supporting the credibility of all 'honest' self-regulation schemes.
- 6.13 There is a specific mandate under the Consumer Protection Regulations for enforcers to support 'honest' self-regulation. See **Box 6.5** for a discussion on self-regulation in these regulations.

Box6.5: Self-regulation in the Consumer Protection from Unfair Trading Regulations 2008

Under the Consumer Protection from Unfair Trading Regulations 2008, (which are enforceable by both the OFT and Trading Standards Services), it is likely to be a misleading practice if a trader who has undertaken to be bound by a code of conduct, and has indicated that he is bound by it, then fails to comply with a business and verifiable commitment in that code, resulting in a consumer taking a different decision.

For example, a trader could be a member of a code of practice that promotes the sustainable use of wood and uses the code logo in an advertising campaign, where the code of practice contains a commitment that its members will not use hardwood from unsustainable sources. However, if it is found that the product advertised by the trader contains hardwood from endangered forests, this practice is likely to be a breach of a firm and verifiable commitment. As the typical consumer would expect code members to sell products which comply with their codes, such a practice would likely be a breach of the Regulations.

The Consumer Protection From Unfair Trading Regulations 2008 also ban the practices of claiming to be a signatory to a code when the trader is not; displaying a trust mark, quality mark or equivalent without having obtained the necessary authorisation; claiming that a code of conduct has an endorsement from a public or other body which it does not have; and claiming that a trader or a product has been approved, endorsed or authorised by a public or private body when the trader or product have not, or making such a claim without complying with the terms of approval, endorsement or authorisation.

6.14 Third and final, as discussed in section three and five, both competition and consumer law **provide a general legal backstop against which all self-regulation schemes operate**. Competition law prohibits and sanctions self-regulation which, on balance, has a negative impact on competition. It should, for example, protect consumers by preventing unjustified restrictions on entry or price competition. Meanwhile, general

consumer enforcement law prevents and deters businesses from lying about quality and punishes them when they do.

FORM OF SELF-REGULATION SCHEMES

- 6.15 The form self-regulation schemes take will be important to regulators who want to consider their impact on the market or whether they will be the most appropriate solution. These forms can vary in numerous different ways. For instance, scheme can vary in the way they are structured, the devices they use to adopt rules or standards and how they enforce those rules or standards.
- 6.16 The discussion below, however, focuses on just two overarching considerations, rather than practical or operational differences. First, whether schemes are voluntary or compulsory (where compulsory means you must be a member of the scheme to operate in the market). Second, whether there is a single scheme or multiple schemes in a market.
- 6.17 Compulsory membership of a scheme will cover the entire market. This has an advantage because the free rider problems can be completely eliminated: there will be no limitations on the reach of the scheme arising from a need for consumers to be aware of the difference between members and non-members. Complete coverage under a compulsory scheme also has an advantage over voluntary schemes since the latter can leave some consumers (who buy from non members) exposed. Finally voluntary schemes, compared to compulsory schemes, have a greater dependence on consumer awareness and this could mean that their success is more sensitive to the number of members. More members improve consumer awareness of the scheme, while fewer members risks schemes failing to generate enough consumer interest to attract businesses to join.
- 6.18 On the other hand, widespread coverage under a voluntary scheme (and at the extreme complete coverage under a compulsory scheme) could also increase harm. The potential for increased harm exists because an appreciable effect on competition is less likely if the proportion of businesses involved in self-regulation is small. If businesses exist

outside the scheme which can offer alternatives to consumers, then a scheme's ability to distort competition is more limited. For example, a scheme which sets quality standards higher than consumers demand (see paragraph 5.8 (b)) would not be as effective if non scheme members were still offering lower quality products.

- 6.19 Compulsory schemes have a further disadvantage over voluntary schemes in that they need to be mandated by governments. This means that they will tend to be more prescriptive about the type and level of quality offered and cannot go beyond the law. The need to mandate means that they are likely to be resource intensive to regulators and so will be used only when benefits of doing so are compelling. Thus they are not a solution in every circumstance.
- 6.20 In general, voluntary schemes are preferable in markets where niche businesses want to signal quality and go above the letter of the law as such schemes offer greater flexibility. Compulsory self-regulation is likely to be of particular value when consumers do not shop around and/or detriment is high if they receive low quality, or when voluntary schemes can not gain enough coverage to sustain themselves or be influential in the market.
- 6.21 Similar issues arise when exploring the optimum number of schemes in the market. An industry which has multiple, competing schemes is less likely to be harmful to competition and offer greater consumer choice than a single scheme. A single scheme may also cause members to gravitate to a single quality level, limiting the choice within the market⁷⁴.
- 6.22 Multiple schemes however, could be confusing to consumers and in the extreme fail to improve quality signals in the market. Multiple schemes (like voluntary schemes) might face problems if each scheme cannot gain enough membership to generate sufficient income to be sustainable

⁷⁴ Although this affect is mitigated if the single scheme just stipulates that businesses cannot lie about quality or there is competition outside the scheme.

(especially if consumers are not making effective choices due to confusion).

- 6.23 In general, multiple schemes might be preferable unless the market is complex and information on schemes will be hard for consumers to obtain and understand or if multiple schemes cannot generate enough revenue to sustain themselves.

BROADER APPLICATIONS

- 6.24 Although this paper has focused on the incentives of industry to self-regulate, sometimes government also has an interest in bringing about a form of 'self-regulation' through a government sponsored arrangement. Government sponsored arrangements seek to encourage producers to tackle issues in order to achieve wider policy goals (including sometimes goals which are not related to quality or which may not be in industry's self-interest).
- 6.25 A good example of this is environmental standards. The recent OFT report on 'environmental product standards'⁷⁵ highlights that part of the driver for environmental standards is to make consumers take into account the full (environmental not just financial) costs of their purchases. One of the market failures set out as being addressed is *'consumers ignoring lifetime product running costs and environmental impacts when buying a good because the product is used by someone else'*. (e.g. a landlord choosing a washing machine for a tenant.) This is an issue which arguably industry has little voluntary self-interest in addressing⁷⁶.

⁷⁵ 'Competition impact of environmental product standards – A report prepared by Frontier Economics for the OFT' (OFT1030).

⁷⁶ As Frontier Economics report states 'businesses may not wish to commit extra to energy efficiency improvements if they fear customers will not be prepared to pay for extra, so policy interventions may be required to push businesses to greater efficiency improvements.'

6.26 **Box 6.6** outlines the Energy Using Products Directive and shows how self-regulation is suggested as one way in which businesses might meet these environmental commitments.

BOX: 6.6 - Energy-using Products (EuP) Directive⁷⁷.

The Energy-using Products (EuP) Directive was adopted in 2005. It establishes a framework under which manufacturers of most energy-using products are obliged to reduce energy consumption and other negative environmental impacts occurring throughout the product's life cycle.

The Directive covers most significant energy-using products which meet a dual requirement to have a 'significant environmental impact' at present and to exhibit clear potential for improvement without entailing excessive costs. The Directive does not prescribe a single way in which the environmental benefits should be achieved. Instead, it allows for a range of implementing measures. **This includes 'self-regulation' by the industry 'where such action is likely to deliver the policy objectives faster or in a less costly manner than mandatory requirements.'**

ADVANTAGES OF SELF-REGULATION OVER EXTERNAL REGULATION⁷⁸

6.27 When some form of regulation is needed regardless of whether it meets the narrow definition in this paper, self-regulation can be preferable and more effective than external regulation and enforcement⁷⁹. Broadly

⁷⁷ Drawn from 'Competition impact of environmental product standards – A report prepared by Frontier Economics for the OFT' (OFT1030). Also Eco-Design of Energy Using products (EUP) Framework Directive 2005/32/EU

⁷⁸ This external regulation is that which is above and beyond the standard enforcement of consumer and competition law.

⁷⁹ Not surprisingly these advantages are in places identical or similar to reasons why self-regulation can support and enhance consumer enforcement. The distinction here is that these refer to advantages compared to external regulation which may be distinct from advantages compared to existing consumer law.

advantages of self-regulation are that they may be better placed, better able, or better resourced to provide effective regulatory solutions because:

- a) **rules are developed by those directly involved in the industry.** This allows industry expertise to be used and this sense of ownership is argued to be more likely to secure high levels of compliance;
- b) **self-regulation schemes have more knowledge of the market** and so are better able to design rules to tackle specific industry problems. This industry knowledge can also assist in the monitoring and enforcement of quality standards. External regulators may be unable to observe the industry as closely to make regulation efficient. For example, external regulators might not know industry costs, technical possibilities or demand in the industry.
- c) **self-regulation is quicker to achieve and more flexible.** Industry can move more quickly than government both in setting up new rules or adjusting them to respond to emerging issues in a market;
- d) **self-regulation can free up time and resources for regulators,** leaving them to deal with higher priority issues. This can be particularly important where it is disproportionately expensive or difficult for government to acquire the specialist knowledge to regulate effectively;
- e) **self-regulation can place less of a regulatory burden on businesses.** Self-regulation schemes might have better expertise on what is reasonable in relation to aims and risks and be more able to maximise regulatory benefit whilst minimising business costs; and
- f) unlike external enforcement, **self-regulation can go beyond requirements in consumer law** and they can **enforce the spirit rather than the letter of consumer law.** For instance, redress under consumer compensation schemes often go beyond requirements of consumer law.

DISADVANTAGES OF SELF-REGULATION COMPARED TO EXTERNAL REGULATION

6.28 Pursuing self-regulation as an alternative to external regulation can however also have disadvantages. These disadvantages largely come from the possibility that self regulators might have interests and objectives that are not closely aligned with those of consumers⁸⁰. External regulation may have better alignment with consumers because:

- a) **self-regulation is more likely to lead to competition concerns**, as it necessarily involves businesses that are competitors collectively altering or agreeing to alter their behaviour. External regulators have a clear advantage over self regulators because they do not have any incentives to restrict competition;
- b) self-regulation schemes that form only under a threat of external regulation might **merely do enough to stave off external regulation**;
- c) **external regulators may be better placed to take a longer-term view** than self regulators concentrating not just on current customers but also on the outcomes for future customers; and
- d) **external regulators are not as vulnerable to capture** or undue influence by members, and thus could do a better job at ensuring compliance (despite potentially having greater difficulty observing conditions of the market);

6.29 Another major disadvantage has already been discussed; in practice **self-regulation is usually voluntary and so does not cover businesses that are not members of a scheme**. This means that it must rely on consumer awareness and shopping around. Here external regulation might be preferred because it has complete coverage. Although compulsory self-regulation would also correct the coverage problem.

⁸⁰.A discussion of public policy failure is outside of the scope of this paper

6.30 Overall the impact on consumers of self-regulation is likely to depend on the alignment of interest between industry and consumers. Where industry and consumer interests are aligned the disadvantages (risks to competition, risks doing just enough to stave off threats, etc) will be minimised and the benefits (better resourced, better placed) will be allowed to shine through.

7 CONCLUSION

- 7.1 Sometimes consumers' inability to observe quality, can lead to quality levels which are lower than both industry and consumers would desire.
- 7.2 Both consumer law and the individual actions in the market offer potential solutions but they have their limitations. In particular, enforcers of consumer law have limited resource and ability to actively police quality (or to set quality above basic levels); while market-based solutions may be too costly for some or may fail due to coordination problems (businesses will free ride on each other).
- 7.3 Self-regulation (for example schemes which set standards) can help to remove problems with observing quality by helping to offer better quality signals, by changing the incentives businesses have to lie about quality, or by making it less important that consumers observe quality by monitoring it for them.
- 7.4 Schemes may be a better instrument than consumer law or independent market-based solutions in particular if they are able to more easily or more effectively: go beyond what is legally required; tailor rules and guidance to specific industry problems; overcome free rider effects; allow businesses to share costs of redress and reputation building; and rely less than independent market-based solutions on the actions of individual consumers and businesses.
- 7.5 There are, however, potential risks, to allowing businesses to coordinate and reach collective agreements. Consumers could be misled if quality signals are false or are misunderstood. Competition concerns could also arise because self-regulation can provide opportunities for anti-competitive practices.
- 7.6 External regulators have an important role to play in making sure self-regulation is as effective as possible and any risks to self-regulation are minimised. First, they can do so by increasing the benefits to joining or forming a self-regulation scheme, sometimes through the credence and

support offered by Government endorsed schemes, and sometimes through altering incentives via threats or compulsion to join a scheme.

- 7.7 Second, they can help self-regulation by strengthening the environment in which genuine schemes flourish. Finally, both competition and consumer law provide a general legal backstop against which all self-regulation schemes operate.
- 7.8 On the one hand, the benefits of self-regulation compared to external regulation are predominately that self-regulation schemes may be better placed or better resourced to provide effective regulatory solutions. In particular, self-regulation can play an important role in improving the market functioning in areas that are not a priority for regulators and it can save on enforcement costs to regulators as it can act as a form of industry-led compliance. Self-regulation schemes may also offer further advantages by going beyond legal compliance in particular because they can set higher standards than required by consumer law.
- 7.9 Self-regulation, however, may also have disadvantages, predominately that a self-regulatory body might have interests and objectives that are not closely aligned with those of consumers and may be anti-competitive. The impact on consumers of self-regulation will depend to an important extent on this degree of alignment of interest between schemes and consumers.
- 7.10 Overall, self-regulation schemes can bring benefits to consumers and may do so in a way that is preferable external enforcement. There are however risks, specifically that competition could be harmed or that ineffective self-regulation could serve only to 'mislead' consumers by offering false quality signals.