

Consumers are More Important than Some Think

AUTHORS:

William Beranek, Professor Emeritus of Financial Economics, University of Georgia

David R Kamerschen, Distinguished Professor of Economics, University of Georgia

ABSTRACT:

This paper adds to the literature that studies the effects of improvements in consumer skills on the degree of vendor competition. Historically, competitive models have largely taken consumer skills for granted, along with consumer self-interest, in the gathering, processing, and evaluation of raw information. Self-interest was expected to be sufficient for reaching optimal decisions. But we study the likely effect improved consumer skill levels can have upon intensity of competition, leading to the conclusion that the more skillful consumers are in performing their buying function, the lower vendor prices will tend to be; just as an overall increase in producer costs puts an upward pressure on prices. Of equal importance, is the higher likelihood that competition will be maintained. This not only leads to potential benefits for **all** consumers, both skilled and unskilled, it suggests opportunities for public policy to improve consumer skills at the elementary-secondary school level, which lead to social benefits.

Well-informed consumers and investors play vital roles in the competitive price-determining process. As consumers, they exert a powerful influence on generating the level of prices. As investors, they support the development and pricing of a variety of investment products. Originally, few economists recognized the former function (Bowman 1951). Recently, however, a growing literature has developed including the subject of unawareness and shrouding whereby informed consumers may help the uninformed ones (see e.g., Gabaix and Laibson 2006), and developments in marketing and economics on consumer learning and expertise (see e.g., Mitchell and Dacin 1996).

We wish to explore the treasure of opportunities that lie within easy reach of every consumer. These keys consist of making available to consumers a knowledge-base identifying shopping skills and how they can be employed to achieve greater individual satisfactions. This, we argue, will tend to increase competition among vendors, and help assure the success and survival of honest, efficient and low-cost firms. It is in the interests of vendors to support improvement of consumer skills.

Explained also is how even modest skill improvements benefit not only the individual, but other consumers as well, who become, in effect, “free riders.” Obviously, the more widespread these improvements become, the greater the benefits to society. Given these attractive results to both individuals and society, how might they be attained? It is suggested that the most effective way to improve such skills is most likely through a program of public education.

One of our purposes is to identify further the role that consumers play in contributing to effective competition. The central thesis is that the more skillful the consumer, in the sense of having analytical tools and raw information, and the more widespread these skills are distributed among such buyers, the more intense is likely to be competition among vendors. So more skilled consumers not only benefit themselves, which is socially beneficial, but also society through competitive effects

Finally, it is shown that the famous analogy of the invisible hand (Wikipedia, The Free Encyclopedia), applies to the consumer area as well as the retailer-producer domain.¹ Consumer skills are obviously essential in the performance of the invisible hand. This does not constitute rediscovering the invisible hand; rather, it extends it by demonstrating the role of enhanced shopping skills in providing more benefits to society.

The Core Idea

In the broadest view competition exists not only among sellers, but also among buyers. The former types are familiar to all; the latter is illustrated in the extreme case by auctions. Shopping skills are invaluable to the consumer in each endeavor.

Consumers' possess two basic sets of information. One is a collection of facts pertaining to the product of interest. These include price, terms of sale, quality, warranties, identities and location of firms offering the product, their reputations, quality of service and so forth. The second kind of information is a set of analytical tools, or skills, with which the consumer develops and evaluates raw data. Some refer to these talents as "information processing skills." (Of course, other skills may be delineated but doing so is not necessary for our purpose.)

Whether raw information or tools, however, costs are incurred in their acquisition. Increasing these forms of information enables the attainment of improved consumption decisions. As is well known from economic theory, the consumer tends to access information until its expected marginal value is equal to the marginal cost of acquiring it (Stigler 1961).

Basic Assumptions

In standard economic theory, the individual achieves an allocation to maximize his satisfactions. Rationality implies a goal-seeking individual who will shop around, collect information, and purchase from the most attractive vendor. He seeks, and gets, more offers. The more consumers are so motivated and skilled, the greater is the pressure on vendors to offer better terms. Moreover, it is intuitively clear that, given the number of competitors, the greater the

number of aggressive consumers, the more intense will be the competition. This may contribute, in turn, to added competition down the supply chain. Following the usual analysis, this leads to the survival of the most efficient firms in each line of business. Consumer rationality, which uses the best information that is economically available, contributes significantly to this competitive setting. Intuitively, one can make a strong case that it is virtually necessary for a significant degree of competition.

To serve in the discussion that follows, it is useful to define **primary benefits** from added skills as direct individual benefits, with the rise of competitive pressures, lower prices and better selling terms as **secondary effects**.

Some Useful Implications

The more informed consumers are, the more efficient tends to be the pricing of goods and services. And, as is well known, prices will tend to embody the best available information. In the allocation of society's resources, prices as guides become more **effective**.

A potentially important benefit of enhanced skills is their ripple effects. Benefits from more acute skills can not only radiate horizontally, but up and down the supply chain as well. Competitive pressures also tend to induce harder bargaining between the firm and its suppliers. While daunting to trace, these tendencies are present.

Also apparent is that with enhanced shopping skills, and the attendant improved competition, the more difficult it becomes for a vendor to inflict fraud and deception upon the consumer (see e.g., Nagler 1993). As consumers become more discerning and use their clout, a markedly more competitive environment will tend to weed out the more opportunistic vendors. This reduces the need for government consumer protective bureaus, such as the CFPB. In fact, the mere existence of these agencies tends to decrease consumer incentives to acquire skills that can vet fraud and deceptive acts, knowing they have a protective backup should they become victimized.

If expanded information spawns more competition, this can have further desirable social outcomes. Lack of effective competition is frequently cited to support increased government regulation. Increased competition can reduce political pressure for more regulation, thus reducing public expenditures. Also, decreased regulation tends to reduce business costs, putting an added downward pressure on prices.

The dynamics of firm adjustment to increased competition can lead to different outcomes. Once a given wave of enhanced shopping skills has been absorbed by the competitive process, product prices are expected to settle down. But if product costs increase for any reason, product prices may rise. This does not preclude the appearance of innovations and new technologies leading to yet another surge of increased competition followed by a downward pressure on prices. In a competitive environment, there is no permanent set of product prices.

Antitrust Implications

Since the foregoing implies that if wise, well-informed consumers are important to effective competition, then it is possible to have effective competition in a line of business with few producers as long as consumers are sufficiently astute and informed. Therefore, it may not be wise to base entire antitrust policy on the number of producers in an industry, or on market share held by a producer. If consumers are not acting responsibly, competition can be weak, encouraging the emergence of a so-called dominant firm. This implies that the current emphasis in antitrust enforcement on producer market share may be misguided, since it may be due to weak consumers. A more refined analysis would consider the quality of consumer skills.

What may be of even greater importance is the shifting of a chunk of antitrust regulatory resources to the teaching of shopping skills among the youth to help maintain competition.

Robustness of Implications

Over centuries, competitive models have been refined and subjected to intense empirical scrutiny, and their major predictions confirmed. Hence, economists have confidence in their usefulness in generating predictions about firm and industry behavior. Since the current analysis is anchored to the foundations of these models, this confidence is expected to transfer to the empirical plausibility of primary and secondary effects, even though their measurement can present challenges. For example, the presence of a plethora of information gathering services and consumer analytical tools is certainly associated with their social need and importance. Moreover, the response of consumers to network marketing sites, such as **Morris Communications Daily Deals**, **Groupon**, and **Living Social**, offers further evidence that some consumers are eager to search for better buys. Opportunities will spontaneously arise for social media outlets, like **Tweeter** and **Facebook**, to serve as transmission channels for shopping skills and information.

The Invisible Hand

Economists usually view the consumer as an important source of consumption expenditures for enhancing gross domestic product, as a vehicle for stimulus spending to benefit the economy, not often examining his role as a vital factor in the efficient allocation of society's resources.

Adam Smith (1776) expresses the famous analogy of the invisible hand in explaining how competitive firms, acting in their self-interests, benefit consumers. But if our analysis is correct consumers, too, play an important role in this process. Acting in their self-interest to pursue best buys, they reinforce competitive intensity at the retailer-producer level, helping insure that the lowest prices prevail and that the most efficient, least-cost firms survive. More importantly, however, it draws attention to the fact that consumers, acting in their self-interest benefit society. The invisible hand is important in both consumer activity as well as retailer-producer behavior. Moreover, people who do not add to their consumer skills and yet are beneficiaries of secondary effects induced by others become "free riders."

These insights imply opportunities for social benefits from enhancing individual shopping skills. This is not rediscovering the “invisible hand,” rather, it is extending it so that its potential benefits can be further developed and made available to all.

Further Reflections

While any endeavors that enhance consumer skills are useful, the most direct effort to reach the citizen is through the public educational system. These efforts, hopefully researched by inspired and dedicated visionaries, are waiting to be developed. Any progress would be socially beneficial. But even if the effort fails to achieve secondary benefits, individuals will personally benefit and that is socially beneficial.

It is natural to ask what actions society may pursue to improve consumer incentives, and hence, the skills of the less skilled. Although finding avenues for such enhancements is the task of another paper, we provide a sketch of steps that may be examined. These suggestions apply as well to developing individual investment skills.

First, is the recognition that innovators in free markets will continue to develop and market increasingly efficient information-gathering facilities, more efficient methods of processing information, and other such skills. There will be Steve-Jobs like visionaries. Since information technology promises to continue to develop, this area will draw growing attention and more resources.

Second, general education can be of great assistance. Attempting to reach the bulk of the adult population is daunting. The more effective path to educational success is through youth, starting with elementary school. The notion of developing shopping skills should be planted in a child's life as early as possible, and then nurtured **throughout** grade school, where skills that are more sophisticated are added as the child matures.

Allocation of public resources to the development of shopping skills is more socially beneficial than appears at first blush. The ultimate increase in secondary benefits they bring

help all members of society, not just those whose personal skills have been enhanced. But since a portion of grade-school resources are often currently devoted to consumer education, it would be useful to consider re-allocating a portion of that sum to developing stronger, more effective shopping skills. (This concept must not be confused with the traditional Home Economics program. There is some overlap here, but the latter serve a useful yet different function.)

Increasing shopping skills would embrace tools to understand and evaluate standard financial contracts, often the most important agreements most consumers will ever enter into. Introducing, for example, the rudiments of financial skills in grade school with more added as the child matures, would be of great benefit to the child, and to society. Homes and autos are often the biggest investments most citizens make, yet only a few have the skills to evaluate mortgages and financial contracts². Having a semblance of such skills could enable wiser choices and, what is most important; help prevent housing bubbles, such as those that recently engulfed the U.S. and Spain. Individuals and society benefit from more knowledgeable, wiser consumers.

Ways to Improve Educational Programs

First, the concept of a contract, an agreement, a “meeting of the minds” should be introduced early in the child’s training process. Even when children play “store”, they can and should practice making contracts. Establishing what the vendor promises to provide should be a habitual negotiating act.

Second, the search process can and should be improved. Techniques and methods for searching for product information, availability of products, prices, and sales terms are either being applied or waiting to be developed through new computer software and network developments.

Third, teaching shoppers to be constantly aware of substitutes for the products they seek. This entails another search procedure. All of these suggestions are active areas for consumer research.

Fourth, not only do we need more research in the development of better shoppers, we require more research in developing more effective teaching skills, that is, the training of teachers who teach grade school. But we also need pedagogs who can train graduate students at the highest level, where consumer research constantly strives to develop all aspects of shopping skills.

Fifth, at professional conferences on consumer research special sessions could be designed to encourage research on shopping skills and on their teaching.

Finally, there are attractive opportunities for imaginative consumer-research graduate students, who thrive on challenges, challenges that involve the development of curricula at all levels leading to the generation of a self-perpetuating process.

Summary

Rational consumer activity is important in securing effective competition, a factor that deserves more attention. Enhancing consumer skills bring immediate results, or primary benefits, for the motivated consumer. But by enhancing competition, however, they produce secondary benefits to the less skillful, as well as added benefits to the more skilled. Vendors tend to respond to increased pressures with potentially lower prices, better services, and other benefits. This produces, in the weakest case, the maintenance of minimal competition; the stronger result, however, is increased competition which benefits all consumers.

Because consumers benefit when their information sets increase, efforts to expand their skills, especially for the less informed, benefits all of society. This suggests consideration be given to allocating public resources, or reallocating a share of consumer education budgets, for the development of these skills among children and young adults. At the least, such efforts can

lead to expanded primary benefits, which are socially desirable. But if secondary benefits are achieved as well, overall social benefits are magnified.

Finally, while many economists react to reports of consumer fraud, deceit and rip-offs with the plea for more regulation, we suggest that by allowing the discipline of the market to exercise its force through improved consumer skills, pressures for added regulation are softened, further conserving public resources.

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Endnotes

¹ The metaphor “invisible hand” is used in Adam Smith (1776).

²In this connection, there is empirical evidence that U.S. people of low income have the weakest shopping skills (see Federal National Mortgage Association (2012)).