COOLING-OFF PERIODS FROM A LAW AND ECONOMICS PERSPECTIVE

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ABSTRACT: From a law and economics perspective, the cooling-off periods are assumed to improve the choices of consumers under monopoly and information asymmetry. Consumers are less knowledgeable and economically inferior to producers and traders when they are exposed to aggressive sales techniques. In a perfect competition market, the firms set the marginal costs equal to the price and to the marginal consumer benefit. In an imperfect market economy, the information asymmetry develops from the inability to estimate the trade-off between the marginal costs, the marginal benefit and the relationship between producers and consumers. Under information asymmetry, the allocation of resources is not economically efficient because it affects the price, the quality and the future of goods. Due to cognitive and motivational constraints, certain commercial practices may negatively affect the process of obtaining, processing and accepting the information by the consumer. The consumer law should create opportunities to evaluate the social efficiency of cooling-off periods as a tool to correct the situation monopoly, the information asymmetry and any irrational behaviour. Our arguments will focus on such phenomenon, which may display fatal consequences for the health of consumers.

Keywords: Law and economics, asymmetric information, bounded rationality, moral hazard, costs.

1. Introduction

In this article, we make use of a normative and positive economic analysis of the consumer law with respect to cooling-off periods. Our positive analysis focuses on the economic models applied by the law in cooling-off periods, whereas our normative analysis provides options how the cooling-off periods should be legally designed in order to be socially efficient.

2. The economic rationale behind cooling-off periods

From a law and economics approach, cooling-off periods are considered to bring an efficient solution. These periods aim to improve the choices of consumers caused by cases like monopolies and asymmetric information, supposingly lasting long enough for the adjustment to occur. The rationale behind this approach, is related to the fact that consumers are less knowledgeable and economically inferior to producers and traders especially when consumers are exposed to aggressive sales techniques. Information with respect to market products is transmitted to consumers through various market mechanisms, but the related information level is not perfect.

3. Cognitive, motivational constraints and bounded rationality - aspects of human behaviour

We assume that a consumer makes a rational purchase decision when the costs to obtain information do not exceed the value of information itself. The second condition applies when costs to obtain the information and communication does not exceed the value of information obtained. However, behavioural economics' scholars admit that empirical studies demonstrate that cognitive and motivational features restrict the ability of human beings to receive and process the information efficiently.[1] Following this logical path, we could argue that consumers encounter aggressive marketing practices such as door-to-door or mail-order sales as well as "market information overload" influencing their ability to make rational purchase decisions.

For instance, in door-to-door sales, a consumer is rationally restricted by "bounded rationality" to make a deliberate purchase decision within time limitation. Other limitations include checking the quality attributes of such goods, emotional manipulation, lack of possibility to consider alternative options like substitutes, pressure exercised by the seller/producer applying "aggressive marketing practices" which lead to information asymmetry toward the consumer. In this regard, cognitive mechanisms might be applied to "distil masses of information into understandable bites, to make the uncertain less so, to make simplify choices and conserve the increasingly scarce cognitive resources on which a complex world places heavy demands".[2]

The provision of cooling-off period might be considered unnecessary if we assume that consumers will learn from their past experiences by correcting some cognitive biases related to their irrational purchase choices. Positive and negative answers are found in the literature with respect to the addressed issue. Lessons learned from past experiences do not mean that the same mistakes or negative cognitive biases cannot be repeated again by human beings. On the other hand, application of cognitive biases is related to the specific techniques for each of them whose efficiency differs substantially.[3] Irrespective of the pros and cons regarding the efficiency of cooling-off periods in consumer contracts, we could affirm that cooling-off periods serve as an instrument to give incentives to the consumer to reconsider and if possible, correct his/her irrational short-term purchase choice(s) and to lead them to the most optimal and future decision(s). We should also consider that irrational behaviour of consumers is not easily identified since it is not directly observed. It is advisable to always rely on empirical studies to provide examples and supporting accurate figures.

4. Efficiency of cooling-off periods

4.1 An endeavour to correct situation monopoly and asymmetric information

The assumption of perfect information in economic transactions is completely unrealistic and information remains imperfect. Obtaining information can be costly, and the extent of information asymmetries is affected by firms and individuals.[4] In a perfect competition, firms set marginal costs equal to price and thus to marginal consumer benefit. In an imperfect market asymmetry of information develops from the inability to accurately estimate the trade-

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[1] Becher, 2007: 169.
[2] Maital 2004: 7.
[3] Becher, 2007:152.
[4] Stiglitz, 2000: 1441.

off between marginal benefit and marginal costs. In situations of asymmetry of information, the allocation of resources will not be economically efficient because it may affect price, quality and the future of goods. Markets where one party tends to have better information than the other party are such as those for antiques, new and used cars insurance, and lending, as seen in 'Market for Lemons'.[5]

A producer gains market power towards a consumer when applying specific commercial practices that induce the consumer to make an irrational purchase which does not meet with his long-term preferences and expectations e.g. door-to-door sales. Then, a cooling-off period would grant the opportunity to the consumer to reconsider the own decision and to differentiate the purchased product(s) from others in the market complying with his/her stable-over time expectations.

If buyers and sellers can resolve the information asymmetries, they can increase benefits by more than their costs. Often it is the case that a third institution is needed to compensate for the lack of information through the creation and enforcement of regulations, monitoring and the settlement of disputes.

4.2 A remedy for weakness of will and defects of rationality of consumers: "bounded rationality"

People are presumed to act rationally in market when the pre-contractual and contractual costs of goods or services purchased by them do not exceed their price. Due to cognitive and motivational constraints (bounded rationality) certain commercial practices may negatively affect the process of obtaining, processing and accepting the information by the consumer. Accordingly, cooling-off periods (right of withdrawal) enable the consumer to give up a short-term preference made under unfavourable conditions for long-term preferences.

Should the cooling-off period be considered as a legal instrument to cure asymmetry of information and irrational behaviour deriving from all types of market transactions by consumer? If yes, we might argue that consumers exercise such a right to correct their short-term purchase decision. But from an economic point of view, the incorporation of cooling-off periods in all consumer contracts aiming at protecting consumers from the information asymmetry does not stand. Purchase price of a product when a cooling-off period is applied, is received by the purchaser after the expiry date of the cooling-off period. Accordingly, the seller would apply a higher price proportionate to the cooling-off period together with any fixed or floating interests over the lost earnings which could lead to higher prices of products. Consequently, a category of consumers would be unable to buy these products anymore.

5. Disadvantages of cooling-off periods

5.1 Moral hazard

During the cooling-off period, consumers are entitled to freely cancel the consumer contract. This situation might lead to opportunistic behaviour from the part of the consumer, e.g. in the

[5] Lipsey and Chrystal, 2007: 289.

purchase of a video recorder through e-commerce, a consumer after making a multiple use of product within the cooling-off period may require to return it and get the money back.

To incentivise to the consumer to deter opportunistic behaviour and moral hazard, we suggest the provision of act-based fines in consumer laws. The amount of these fines should cover the cost of use of returned product (i.e. the product is not anymore brand new), lost earnings of the seller (i.e. he could sell the product to somebody else and get profits on the basis of interests applied over the sale purchase price). The contrary argument regarding this legal proposal could be that due to lack of willingness of the consumer to pay these fines when his/her opportunistic behaviour is identified, the dispute will be brought to the court or to the arbitration authority. Then, litigation costs would be involved.

5.2 Additional costs

Cooling-off periods might be associated with costs for the category of rational consumers that make deliberate purchase choices. To illustrate this assumption, we may refer to the example brought by Rischkowky and Dorung, the case of governmental regulations that aim to protect consumers prohibit changing the coverage by a multi-step legal provision. Consumers acknowledge that they are aware of this legal amendment and that they comprehend its content. If the cooling-off period regulation set forth a longer timeframe for amendments in the abovementioned contract, the consumer might suffer economic losses.[6] If the consumer demonstrates an opportunistic behaviour arising out of the application of cooling-off period that lead to moral hazard issues, a case law may be brought to the court/arbitration authority, involving litigation costs on the basis of its duration. We take into account that moral hazard issues cannot be directly observed by the seller and consequently, it is difficult to prove by the plaintiff in front of a court or arbitration authority.

6. Conclusions

To evaluate the social efficiency of cooling-off periods in the consumer law as a tool to correct situation monopoly, information asymmetry and irrational behaviour, a cost and benefit analysis should be conducted. In this regard, cooling-off periods are socially efficient when benefits exceed costs. With respect to asymmetry of information, we argue that such phenomenon may display fatal consequences especially in products that can directly affect the health of buyers. Recognising the failure of free markets, governments should intervene to help consumers to correctly estimate costs and benefits of their choices, enforce standards which aim to reduce risks, or health damages and improve their marginal benefit.

In order to reduce the problem of moral hazard that causes price increase of products and reduction of offers, act-based fines may be provided to consumer law. Furthermore, by-laws can specify the application of act-based fines in practice, a list of exhaustive cases when these may be applicable each time a problem of moral hazard is identified.

[6] Rischkowsky and Doring, 2008: p. 208.

Empirical research should be conducted to point out the economic efficiency of cooling-off duration periods. To illustrate this conclusion, we may refer to life insurance contract where a length of 14 (fourteen) up to 30 (thirty) days is provided. In the theory of law and economics, is admitted that this length of cooling off periods cannot reduce the information asymmetry that can be assessed after the use of life insurance.[7]

[7] Haupt, 2003: 1145-1160.

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‘PERIUDHAT E REFLEKTIMIT’ NËN KËNDVËSHTRIMIN E ANALIZËS EKONOMIKE TË LIGJIT

Abstrakt: Nën këndvështrimin e analizës ekonomike të ligjit, ‘periudhat e reflektimit’ synojnë të përmirësojnë zgjedhjet e konsumatorëve në kushtet e monopolit dhe të asimetrisë së informacionit. Konsumatorët janë më pak të informuar dhe, nga ana ekonomike, në pozita më të pafavorshme se prodhuesit dhe tregtarët, veçanërisht kur konsumatorët gjenden të zbuluar në kushtet e teknikave agresive të shitjes. Informacioni mbi prodhimet e tregut u transmetohet konsumatorëve nëpërmjet mekanizmave të ndryshëm të tregut, por shkalla përkatëse e informacionit nuk është e plotë. Në një treg me konkurrencë të përkryer, kompanitë vendosin kostot margjinale të barabarta me çmimin dhe përfitimet margjinale të konsumatorit. Në një ekonomi tregu, asimetria e informacionit zhvillohet nga paaftësia për të vlerësuar raportin ndërmjet kostove margjinale, përfitimeve margjinale dhe marrëdhënien ndërmjet prodhuesve dhe konsumatorëve. Në kushtet e asimetrisë së informacionit, caktimi i burimeve nuk është ekonomikisht efikas sepse ndikon në çmimin, cilësinë dhe të ardhmen e mallrave. Për shkak të kufizimeve, disa praktika të caktuara tregtare mund të ndikojnë negativisht në procesin e marrjes, të përpunimit dhe të pranimit të informacionit nga konsumatori. Legjislacioni në fushën e mbrojtjes së konsumatorit duhet të krijojë mundësi për të vlerësuar efikasitetin social të ‘periudhave të reflektimit’, si një mjet për të korrigjuar situata të monopolit, asimetrisë së informacionit dhe çdo sjellje irracionale në treg. Argumentet tona do të përqendrohen në dukuri të tilla, të cilat mund të shfaqin pasoja fatale për shëndetin e konsumatorëve.

Fjalë kyç: Analiza ekonomike e ligjit, arsyetim i kufizuar, informacioni asimetrik, kosto.