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CRITICAL FACULTIES

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The hidden economy

Embedded in everything from cellphone bills to car-rental contracts, "hidden fees" are hiding in plain sight. Two economists explain why they're likely to stay that way.

By Christopher Shea | June 25, 2006

THE PRINTER: It's one of the most common peripherals in the computer age and so cheap—at first blush, anyway—that stores often give them away when you buy a PC. Yet how many people realize, when they walk out of CompUSA, a nice \$99 inkjet model tucked under their arm, that it's likely they've just committed themselves to spending nearly \$1,500 on ink cartridges over the next four years? (In fact, only about 3 percent realize it, according to Stanford economist Robert E. Hall.)

We're living today in the hidden-fee economy. Printers come with a particularly hefty and devious add-on fee in the form of those cartridges, but they're just one of many products with a sneaky price structure. Cellphones, of course, have deadly "overage" charges lurking behind the attractive monthly rates, while credit card companies lure customers with low annual fees then hit them with late fees and higher interest rates if payment is even a day late. (In 2001, banks pulled in \$7 billion in

late fees according to one study.) Comically pricey phone calls and outlandish minibar tabs pad the balance sheets of hotels whose affordable basic room rates serve as a come-on. Low weekly fees for rental cars attract customers, but they get you on the insurance, car seats for the kids, and \$6-per-gallon gas.

Getting nailed by a hidden fee is one of the great annoyances of modern life. But, if it's any consolation, the fees have also raised fascinating questions for economists: Why, for example, don't companies compete on all costs, including the ones in fine print? According to classical economic theory, it shouldn't be possible to conceal price information that's important to the consumer: Competing firms will educate consumers about the other guy's high hidden prices in order to win business.

"We don't think that's right," contends David Laibson, a professor of economics at Harvard and coauthor, with MIT's Xavier Gabaix, of an article on hidden fees that appears in the latest issue of the *Quarterly Journal of Economics*. "We think there are robust market forces that serve to suppress that information, and keep it suppressed."

Laibson and Gabaix aren't conspiracy theorists. Their explanation for the persistence of hidden prices, laid out in "Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets," describes a complex balancing act, in which companies must weigh the costs of educating consumers against the benefits of duping them. And their work relies on the insight, now common in what's called behavioral economics, that many consumers are far less rational than economists used to think.

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Laibson and Gabaix's explanation relies on a good bit of math, too, but it can be summarized pretty simply using a hypothetical example. Imagine two hotel chains. The first, Hidden Price Inn, has a very low room rate of \$80 a night, but makes liberal use of high "shrouded" fees: Three bucks for a minibar Dr Pepper, \$25 for parking, \$12 for eggs at breakfast. The unsophisticated traveler cheerily (if unwittingly) forks over the fees, all the while patting herself on the back for getting a cheap room.

Now imagine a second chain, Straightforward Suites. It charges much more reasonably for the extra costs (\$1, say, for that Dr Pepper), but because it makes less on the extras, it has to charge slightly more for the room—\$95, instead of \$80. Even an unsophisticated traveler can tell \$95 isn't as good as \$80.

Through an aggressive ad campaign, Straightforward could try to point out how devious the approach of Hidden Price Inn is and how much less deceptive its own prices are. But Laibson and Gabaix show that there's a catch in this strategy: Hidden Price Inn actually has two key types of customers. Yes, there are the clueless consumers (the economists prefer to call them "myopic"). But there are also the sophisticated ones, who know that if they avoid the hotel restaurant, take a taxi instead of using the parking garage, and call home with a cellphone, they'll actually get a better deal at Hidden Price than at Straightforward.

Straightforward Suites's ad campaign, then, might just end up increasing the ranks of sophisticated consumers who will in turn dial up Hidden Price Inn for a cut-rate room. Rather than play this self-defeating game, Straightforward will most likely just lower its own room prices and stick it to the customers on the extras.

The specifics may vary from industry to industry, but Laibson and Gabaix argue that this basic dynamic helps explain why we see shrouded fees across the economy. Regulations requiring companies to be more up-front about their prices might help in some cases, they say. But, being economists, they distrust regulation. As long as these games exist, they conclude that your best bet is to be a sophisticate. Laibson offers this tip in particular: "Print in draft mode, don't gratuitously print things that you don't need, and when in doubt, print at work. Those simple pieces of advice will save you about \$500 a year."

But not all economists think it makes sense, even in self-interested terms, for companies to embrace the hidden-fee economy. Barry Nalebuff, a professor of business strategy at the Yale School of Management and author of "In Praise of Honest Pricing," which appeared in the MIT Sloan Management Review in 2003, says Laibson and Gabaix's article fails to consider that annoying consumers has a cost: It drives them away.

"In the end, you don't fool the customers with the hidden price," he says. "They know they've paid it even if they didn't know they were going to pay it." And if they feel ripped off, they won't come back. In the cellphone industry, he says, carriers lose 40 percent of their customers each year, a tremendous "churn" rate that industry players are starting to take note of. Sprint, Nalebuff points out, recently began pushing what it calls its "Fair and Flexible" plan, which adjusts customers' calling plans to minimize overage charges. Sprint is betting, in other words, that customer loyalty is worth more, in the long run, than sneaky fees.

Laibson, though, has his doubts. Companies that hide fees "may lose some customers," he says, "but along the way it's a good ride."

ECONOMICS A TO Z: All these economists talking about myopic consumers may sound a bit condescending, so it's only fair to note that two young economists recently diagnosed a particular kind of myopia among economists themselves. In a recent issue of the *Journal of Economic Perspectives*, Liran Einav, of Stanford, and Leeat Yariv, of Cal Tech, made the case that, at the top 10 economics departments, scholars whose last names begin with a letter that appears early in the alphabet are more likely to earn tenure and win top prizes than their colleagues.

Einav and Yariv theorize that early-letter types get an unfair advantage because articles in economics journals tend to list authors in alphabetical order-not, as in other fields, in order of who contributed most to the paper. Readers inside and outside economics may be assuming, perhaps even subconsciously, that the author listed first still deserves more credit.

Reaction to the article has been mixed-and not randomly mixed. "You definitely see a correlation between how much they believe the article and how late in the alphabet they appear," says Einav. Jeffrey Zabel, an economist at Tufts, deems the results "persuasive." The chair of Harvard's department, Alberto Alesina, said he had not read the paper, so he couldn't comment. Hmm.

Christopher Shea's column appears biweekly in Ideas. E-mail critical.faculties@verizon.net. ■