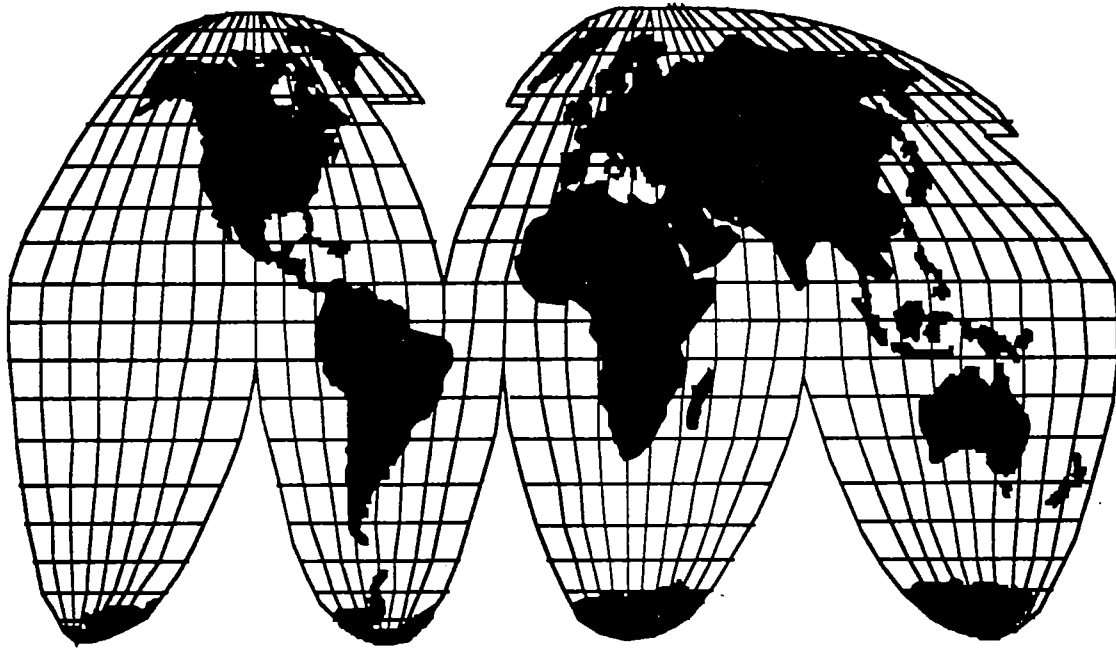


Regulatory Policies and Reform: A Comparative Perspective

Claudio R. Frischtak (ed.)

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Beyond the basics of consumer protection

Eduardo Engel

The importance of consumer issues grows with mass consumption and mass production. In rural societies people produce most of the goods they consume. In such societies consumer policy plays a limited role.¹ As societies industrialize, people abandon the countryside or village and move to the city, where they buy goods and services from anonymous sellers and must choose among different brands of varying quality and price. As incomes increase, goods become more sophisticated and therefore more difficult to judge. Buying a durable good, such as a refrigerator, requires more skill and judgment than buying a shirt, for example, for two reasons. First, it is harder to assess the quality of a refrigerator. Second, because consumers purchase refrigerators more infrequently than they do shirts, they are less likely to know the refrigerator seller and less likely to trust the information provided. When consumers are not familiar with sellers, they also become more vulnerable to deceptive business practices.

As economies develop and the need for both consumer education and consumer protection increases, consumer policies should become a central concern of policymakers.² Educated consumers help a market economy function better. By scrutinizing the products they buy, educated consumers encourage manufacturers to produce high-quality goods. Despite the desirability of consumer policies in industrializing countries, in most cases they play only a secondary role. Understanding why this is so requires considering the political economy of consumer protection policy.

Consumer education also has an important role to play in protecting consumers' economic interests during transition to a market-oriented economy. Once price controls are lifted, the vulnerability to which buyers are exposed increases dramatically. As illustrated by the MMM pyramid scheme in Russia, uneducated consumers easily fall victim to large-scale scams. The chances of success of market reforms is enhanced when citizens perceive the

new economic system as being fair. Consumer education and consumer policies increase dramatically the likelihood that a reform will be successful and the chance that citizens will support it with their votes.

Consumer policies can be divided into two groups, according to whether they attempt to modify the informational environment faced by consumers or to change consumer behavior itself. The former are referred to as consumer protection policies and are covered in chapter 6. This chapter considers policies aimed at changing how consumers behave, which can be called "consumer promotion." Consumer promotion policies are discussed in the first section. The relation between consumer policy and trade policy, and their link with competitiveness and productivity—a topic of growing importance in both developing and industrial economies—is analyzed in the second section. The third section considers the political economy of consumer protection. The fourth gives a detailed account of the MMM pyramid scheme and draws policy conclusions on the role of consumer protection in the former Soviet Union. Topics for future research are suggested in the fifth section, which is followed by a brief conclusion.

Consumer promotion

Regulations protecting consumers work by changing the environment that consumers face. Such regulations have short-run, often immediate, effects. Consumer promotion policies, on the other hand, do not try to change the consumer's environment, but aim to modify the consumer's behavior. They include consumer education and information programs and mechanisms aimed at helping consumers achieve representation and redress, such as consumer organizations.

Consumer education and information

If consumers were better informed and more educated, they would be able to solve many of the problems they

encounter. This is especially true in developing countries, where consumers often lack the abilities needed to uphold their rights. Less regulation is needed to protect more educated consumers. For this reason, consumer education is an important aspect of consumer policy. Another reason concerns consumer safety: Many injuries cannot be prevented through direct regulation. Miller and Parasuraman (1974) concluded that "the fact that at least 80 percent of the consumer product-related injuries may not be caused by defective or unsafe products suggests that consumer education has a very large untapped potential for reducing such injuries."

Consumer education and information programs can reach consumers through a variety of media. In many countries television programs are devoted to discussion of consumer issues; in some, government consumer organizations are allocated a specific number of prime-time minutes per week.³ Some private media (newspapers, radio, and television) also devote time or space to consumer issues. When the media are privately owned, however, the possibility of retaliation by companies portrayed in a negative light through the withdrawal of advertising can limit the educational value of such programs.

Product-testing magazines are one of the most important vehicles for educating consumers. Chapter 6 argues that governments in developing countries should subsidize private product-testing magazines. Examples of product-testing magazines in industrial countries include *50 millions de consommateurs* in France, *Rad and Rön* in Sweden, *Which?* in the United Kingdom, and *Consumer Reports* in the United States, published by Consumers Union. The coverage of these magazines varies considerably, from 20 percent of all households (Norway) to 3 to 4 percent (United States). Some are aimed specifically at children, for example, Consumers Union's *Penny Power*. The potential impact of magazines targeting children is large, since consumer attitudes, habits, and skills, including the ability to evaluate advertising critically, are developed at an early age.⁴

While information regulation is often insufficient to protect consumers—for such an approach to work, consumers must read, understand, and act on the information provided—education campaigns are even more problematic. The standard distinction between information and education programs is that the first are considered *notification* schemes that provide factual information, and the second *persuasion* schemes that convey messages, which may or may not contain factual information and often seek to motivate the public to modify their behavior.⁵

Adler and Pittle (1984) concluded that "the popularity of persuasion campaigns . . . says little about their effectiveness. While we do not challenge the value of all information and education programs, we suggest their popularity rests more on philosophical and ideological grounds than on solid empirical evidence supporting their ability to alter consumer behavior." The fact that education programs often attempt to break deeply ingrained consumer habits compounds the hurdle that such programs must overcome. When a message conflicts with a consumer's prevailing belief, the consumer will reject or distort the message to make it palatable.

An example of the limitations of education campaigns is provided by programs in the early 1980s aimed at promoting the use of safety belts in industrial countries. According to the National Highway Traffic Safety Administration (NHTSA), in the United States in the early eighties, 34,000 people were killed each year—and more than half a million suffered moderate to severe injuries—as a result of highway accidents. If all occupants wore seat belts, motor vehicle fatalities would be cut in half and injuries reduced by 65 percent. Because automobile insurance is more expensive for all drivers because some do not use safety belts, government intervention might be considered appropriate. In addition, because most drivers believe they are better-than-average drivers, they may underestimate the probability of having a car accident and consequently view safety belts as unnecessary. The fraction of U.S. drivers using safety belts increased only marginally (from 11.3 percent to 13.9 percent) after a three-year education campaign by the NHTSA. Even in Sweden and the United Kingdom, where such campaigns were most successful, the percentage of drivers using safety belts never exceeded 35 percent. Although such campaigns are usually cost-effective, alternative mechanisms, such as complete passive protection and mandatory seatbelt laws, prove more effective.⁶

Consumer redress

Consumers should have access to proper redress, through swift, effective, and inexpensive procedures, for injury or damage resulting from the purchase or use of defective goods or unsatisfactory services. Yet consumers with grievances often do not gain redress, in part because the opportunity costs involved in resolving a complaint can be prohibitive.⁷

By giving consumers a voice, a well-functioning redress system can mobilize consumers to play an active role in the marketplace. By contrast, a poorly functioning redress system can lead consumers to exit the market-

place (see Hirschman 1970). A study of consumer complaints in a representative sample of industrial economies found that consumers were dissatisfied with one of every six products they had purchased.⁸ About half these grievances (complaints) were voiced to the sellers, and a satisfactory result was reached in 60 percent of the cases. Of those complaints that were not solved satisfactorily, only 1 to 3 percent were brought to a third party such as a consumer association or an attorney. Only 3 to 5 percent of the complaints brought to a third party were pursued further.⁹ Finally, only 5 to 10 percent of the legal actions that are brought are settled in court; the rest are resolved through out-of-court settlements.

Schemes designed to enhance consumer redress vary across countries. Some redress schemes depend on government initiatives. Others are sponsored by business.¹⁰ Among the former two broad groups can be distinguished. A first group consists of mechanisms aimed at reducing the transactions costs of using the legal system. A second group consists of a variety of mechanisms designed to circumvent the legal system altogether—sometimes called “alternative dispute resolution mechanisms.”

Government-sponsored consumer organizations. The role of public consumer organizations as a consumer coordination mechanism is important in most consumer promotion policies. As Arrow (1970) pointed out, producers collude more often than consumers because they are fewer in number and stand to gain more from coordinating their actions. Lower transactions costs (in this case, bargaining costs) explain why without government action there are more producer associations than consumer associations.

Public consumer organizations can play an important role in both industrial and developing countries by reducing consumers' transactions costs in obtaining redress, gathering and disseminating product information, and representing consumers before government agencies and legislative bodies. In some countries government-sponsored consumer organizations also support networks of citizen advice groups.

Public consumer organizations may also play an important role in enforcing health and safety regulations. In practice, health and product safety regulations are often poorly designed and enforced. Both private and public consumer organizations can play an important role in monitoring regulatory agencies.¹¹ Where search and experience goods are concerned (see chapter 6), it is enough that these agencies receive and channel consumer complaints on lax enforcement.¹² In the case of credence goods, they must act on their own initiative. In the latter case, where the role of “whistle blowing” is most impor-

tant, the cost of monitoring regulators is also highest. An alternative approach for monitoring regulators is to create an independent “regulatory board,” with an institutional design to insulate it from political pressure.

The effectiveness of a consumer organization in promoting consumers' economic interests varies, and it often depends less on financial resources than on commitment and ingenuity. To facilitate consumers' redress, the Canadian Bureau of Consumer Affairs established a special post office box in 1968, and the French government took the same step in 1978. Consumers' letters are received at local branches of the consumer organization, where staff give information and advice and try to reconcile parties. If a problem cannot be resolved, the letter is forwarded to the appropriate government agency or private consumer organization. For such a system to work, the government organization must be efficiently designed and managed. At its peak, Canada's consumer postal box had 60 staff members who handled 56,000 complaints each year.¹³

Business-sponsored redress mechanisms. A variety of redress mechanisms are sponsored by the private sector. One means of redress available to consumers who purchase some products is a toll-free telephone number. More than 200,000 such lines currently operate in the United States, and the concept is making inroads in developing countries as well (see Agins 1990). A related mechanism is repair, replacement, and return policies, as well as warranties offered by sellers. And U.S. companies also frequently establish consumer affairs and consumer service departments to handle customer complaints.

Private arbitration schemes are also used in some countries to resolve consumer complaints. In such schemes, the disputing parties jointly select an arbitrator and agree to abide by the arbitrator's decision. The informality and speed of the procedure (which bypasses the court system) and the finality of the decision often make private arbitration an attractive, less expensive alternative to a court hearing.

Media action lines are yet another redress mechanism. Some newspapers have a consumer action columnist who receives complaints from consumers, contacts the offending business, attempts to mediate a settlement, and publishes the result in the newspaper. Consumer columns can have a powerful deterrent effect. A customer's threat of contacting the columnist may encourage a seller to settle a complaint to the consumer's satisfaction. A limitation of such columns, however, is that newspapers face a conflict of interest when complaints involve their major advertisers.¹⁴ It is not surprising that the complaints pub-

lished in such columns mainly (if not exclusively) involve small businesses or government agencies.

Government agencies can generate media publicity by releasing the results of comparative testing experiments they have solicited or by publicizing the names of companies that have not met government standards. This can be an effective way of promoting consumer protection in developing countries. Simply showing a wide price dispersion for homogeneous goods may alert consumers to the value of spending more resources to search for lower-priced goods. Similarly, exposing the contents of certain food products may prompt consumers to choose more carefully among competing brands.

Redress and the legal system. Reducing the transactions costs involved in bringing a complaint is one way of improving consumers' access to redress, particularly in developing countries, where the legal system can be slow and cumbersome. Small claims courts, such as those in the United Kingdom, make the legal system more accessible to consumers by reducing litigation costs, expediting the procedure, and discouraging (sometimes even prohibiting) parties from retaining legal representation. Allowing the consumer choice of jurisdiction is one way to help keep transactions costs low. India's Consumer Protection Act created a system of courts to resolve consumer disputes at the district, state, and national levels (see Kayak 1987). Although these courts do not have all the features of small claims courts and the procedure consumers must follow is cumbersome, they are a step in the direction of ensuring legal redress for India's consumers.

Class action suits in the United States reduce transactions costs by providing a mechanism for consumers who have a similar complaint against a seller or manufacturer to join together in bringing a lawsuit. Class action suits were instituted to provide incentives to lawyers to take cases affecting a large, diffuse group of consumers. An alternate approach is to give consumer organizations a central role when collective action is called for, as Brazil's 1990 consumer protection law did (see Salgado and others 1994). The Brazilian law gives incentives to consumer organizations to seek redress for consumers by exempting them from judicial costs and fees.¹⁵

The high cost of legal recourse in most countries and the lengthy delay in bringing proceedings to a conclusion have given rise to myriad alternative dispute resolution mechanisms. In many countries government institutions can act as arbitrators in consumer disputes. The recommendations of such arbitrations are usually nonbinding on the parties, although the system in Norway is one exception.

By centralizing information on consumer grievances, government-sponsored consumer organizations can detect when a pattern of deception by a particular seller emerges and take action accordingly. Public complaint boards in Denmark, Finland, Norway, and Sweden provide buyers and sellers a simple, rapid, low-cost alternative to the courts to settle disputes. Although the decisions of these boards are not legally binding, compliance is achieved in 75 to 85 percent of the cases. If the losing party does not comply with the board's decision, the winning party is free to pursue its case in the court system.

Mexico's Federal Consumer Protection Act of 1975 enables aggrieved consumers to follow either of two routes (see Vargas 1989). The situation in Mexico prior to 1975 resembled that of many developing countries today. Warranties and operating instructions of most appliances were written in a foreign language (English), consumers did not know where to go or what to do if a good turned out to be defective, and the courts were unprepared to deal with even the simplest legal complaint related to consumer transactions. Today, the government's Consumer Affairs Office plays a central role in an adjudicatory system to solve consumer disputes. A relatively simple and expeditious binding arbitration procedure is also available. The first stage of the arbitration procedure is carried out in writing, which substantially reduces transactions costs.¹⁶

The relation between consumer protection policy and trade policy

Trade liberalization in many developing countries has forced exporters and government officials in these countries to adhere to more stringent consumer protection policies. Quality requirements for consumer products are usually greater in industrial countries than in developing ones. Moreover, increased access to high-quality goods makes local consumers more demanding. In meeting these demands, local manufacturers enhance their competitiveness. Consumer protection policies in the exporting country are also fostered. A challenge for developing countries is to reduce the risk that local consumers will be harmed by imported products.

Consumer protection as a nontariff barrier

Industrial countries often set higher product standards than developing countries would meet in the absence of regulation. The additional costs that developing-country exporters must incur to bring their exports up to these standards make their products less competitive in global markets. For example, since May 1994 the U.S. Food and Drug Administration has required that food imports into the

United States indicate their nutritional contents as well as the processor, packer, and authorized wholesaler. Environmentally friendly ("green") products that consumers in some industrial economies are demanding are another example. The requirements for using a "green" label may increase costs dramatically for a developing-country exporter, thereby eroding its comparative advantage.

Such standards are usually legitimate. But quality standards are sometimes used as a nontariff barrier to block foreign products from industrial markets. The best-known example is the *Cassis du Dijon* case, in which the European Court of Justice ruled that a German regulation preventing the sale of French liqueur in Germany could not be justified on consumer protection grounds (see Dardis 1988). In recent years developing countries' complaints that industrial countries use consumer protection and safety issues as a nontariff barrier have increased. For example, Japan bans fruit imports from countries in which the fruit fly has been spotted, regardless of whether the location where the fruit is grown is free of the insect. Thus Chile is barred from exporting fruit to Japan because a fruit fly was found in Arica, located some 2,000 kilometers from the Chilean central valley where fruit is grown.

The practice of using consumer issues as a nontariff barrier is not limited to industrial countries. Many African countries ban imports of used clothes, giving as the reason that such garments spread acquired immune deficiency syndrome (AIDS). In Tanzania this accusation apparently was initiated by domestic textile producers (personal communication, D. Kaufmann, August 1994).

Given the higher standards prevailing in industrial economies and the fact that these standards are sometimes used as nontariff barriers, developing countries should promote standardization at both the national and international levels.¹⁷ Although most developing countries have instituted standards to ensure the accuracy of weights and measures used in commerce and to protect consumers from dangerous products and substances, they only recently have become aware that standardization can facilitate exports to industrial economies. John Hinds, president of the International Standards Organization, described the situation at a World Bank seminar in November 1992:

The national standards in industrialized economies can be barriers to exporters from developing economies when they do not know, cannot attain, or cannot certify that they have attained the standards of performance or safety required in the

importing market. To compete effectively in the world market, developing countries therefore need to know the standards of the markets they will be exporting to, have internationally recognized testing and certification organizations, and a national quality assessment system conforming to international criteria.¹⁸

Standardization should go hand in hand with the promotion of the minimal harmonization principle, which the European Union announced after the *Dijon* case. This principle admonishes countries against using standards to bar goods from other countries unless consumer health or safety is at risk.

The coordination of consumer policies across countries could provide a beneficial step. Trading partners aiming at similar levels of quality and safety would benefit from coordinating their consumer policies, since doing so reduces production costs without significantly changing the level of protection provided.¹⁹

In negotiating free trade agreements and customs unions among themselves, countries would benefit from incorporating consumer policy issues into their negotiations. The European Union has acknowledged the potential advantages of doing so by creating the European Bureau of Consumer Unions to coordinate the consumer policies of the 12 member states. This organization will be challenged to propose standards that are compatible across both highly industrial economies such as Germany and France and less industrial economies such as Greece and Portugal. Countries in the first group may complain that the standards are too lax, and those in the second group may perceive even a relatively weak standard as damaging their export industry.

The competitiveness link

A popular argument to allay the private sector's concerns about the costs of promoting consumer protection is that these policies benefit producers by raising their competitiveness. Some observers have concluded that without efficient markets, rivalry, and demanding consumers at home, local industry cannot develop the products, skills, and expertise necessary to compete successfully abroad. More demanding consumers help local firms to test new products and spot opportunities for new product development.

More sophisticated consumers at home may also help potential exporters reduce the risks associated with new investments. Consider, for example, a producer in a developing country considering the export of meat. The absence of a slaughterhouse that satisfies the standards in

industrial economies is an important barrier. If local consumers were more demanding, the start-up costs to begin to export would be lower. In general, more demanding local consumers imply that there will be local demand for better-quality products, ensuring exporters a minimum return on a risky export project.

Finally, it would be beneficial if consumer organizations in developing countries stimulated consumer interest in trade matters, for example, by providing concrete examples of unexplained price and quality differences between countries for certain products. The Consumers Association in the United Kingdom goes a step further: It provides advice to consumers on how to obtain the cheaper product, for example, how to import a cheaper car than one that can be purchased in the United Kingdom (see Linke 1988).

Protection of health and safety

Protecting consumers may become more difficult in developing countries as trade increases because the flow of product information for imported goods may be obstructed.²⁰ Information may be inadequate for three reasons. First, individual consumers and even government agencies may not know how to contact the home office of the seller or manufacturer for additional information. Second, language barriers reduce the value of the information provided, especially if information is in the language of the exporter. Even if information has been translated, translations are often of poor quality. In addition, many manufacturers do not consider the fact that more than one language is spoken in some developing countries. For example, warning labels on imported pesticides are printed in only two of the 15 official languages in Kenya (see World Bank 1984). Finally, in many developing countries high levels of illiteracy create obstacles to the transfer of information, exposing the population to greater health and safety risk.

It is often more difficult for consumers to obtain redress in the case of imported goods, especially when redress must be obtained directly from the manufacturer. International redress may involve two legal jurisdictions, and international law may apply. In such cases, transactions costs become prohibitively high.

Obtaining redress may also be more difficult because certain safeguards aimed at facilitating redress apply only within the producer's country. For example, safety seal providers (such as UL in the United States, SG in Japan, and DIN in Germany) are only liable for accidents that occur within the country of issue. Developing-country consumers would benefit if safety seals with worldwide lia-

bility were developed. At the same time, however, this step would harm developing-country exporters of similar products, who would face higher liability premiums as a result.

Developing countries can adopt policies to reduce the risks associated with imported goods. First, countries can require that imported goods carry labels and other relevant product information in a form that is understandable to domestic consumers. Resources must be allocated to enforce such a policy and to check the quality of translations. Second, countries can encourage the adoption of an international code of hazards. To the extent possible, this code should be based on pictograms. The desirability of such a code is illustrated by a tragedy that occurred in Iraq in the early 1970s. Iraqi farmers used mercury-coated grain intended for seed to make bread, resulting in 6,000 reports of poisoning. Although the manufacturer had colored the grain with brownish-red dye as a warning, the dye was not permanent. Had warning labels been translated or pictograms used, farmers would have understood the dangers the seeds posed.

Third, to provide incentives for appropriate information provision, the importer should be held liable for product-related accidents. Brazil's consumer protection law includes this provision. Such a policy faces two important limitations, however. First, importers may lack the resources to pay damages. Second, in many developing countries consumer access to legal redress is almost nonexistent. The role of government agencies in providing redress is important in this case.²¹

Clearly, there are trade-offs to consider in deciding whether to allow imports of dangerous substances. For example, Thailand's imports of the pesticide DDT dramatically decreased the incidence of malaria and opened up vast new areas for rice and corn production, thereby increasing local food consumption, improving nutrition, and promoting agricultural exports (see Kinsey 1988). But as a World Bank (1988) report noted regarding warnings on pesticides sold in Kenya, "Even if the consumer can read and understand the warnings, it is not easy to 'avoid contaminating rivers,' nor to 'wash with soap and water after use.' Most users have never seen a physician, and certainly are not able to consult one 'immediately' as advised by the label."

Considerable attention has been paid to the export of unproven or dangerous pharmaceuticals. A double standard in some countries allows their pharmaceutical industries to export drugs whose use is banned domestically (Micklitz 1988). One solution is to require manufacturers to inform responsible authorities in importing countries of the potential danger—the "informed consent"

approach. As long as health authorities are accountable for their decisions to allow the import of pharmaceuticals that have been banned in the country of manufacture, the informed consent approach may prove more successful than other information provision regulations. The main reason why export notification has not been discussed internationally is that the World Health Organization (WHO) has advocated tougher measures to deal with the double standard problem. For this purpose, WHO has designed a certification scheme that gives quality guarantees for exported products. In February 1988 the European Community published a draft resolution on the export of pharmaceuticals. It calls for member states to directly notify WHO of all regulatory actions, voluntary suspensions, and recalls.

The politics of consumer protection

Although the number of people who stand to gain from consumer protection is often significant, consumer protection has a hard time finding political support because its benefits are so diffuse. While the aggregate gains can be large, often no individual has an incentive to become a consumer advocate. Yet, producers can easily mount a force to combat consumer protection legislation.

As the history of consumerism in the United States shows, high-profile, credible, and charismatic consumer advocates can play an important role in promoting legislation favoring consumers (Creighton 1976; Mayer 1989). Ralph Nader helped promote consumer issues in the United States during the 1960s and 1970s, when social activism was high in both developing and industrial countries. Nader believed that U.S. car manufacturers could build safer cars and that the market system would function more effectively if consumer organizations provided the missing checks and balances.²² Cars manufactured by U.S. auto makers are considerably safer today, thanks to safety regulations prompted by consumer activism. Nader and his Nader's Raiders, as his followers were called, also worked to ensure that the government agencies mandated to protect consumers did not become co-opted by the interests they were supposed to regulate.

During the 1960s and 1970s incentives for the emergence of consumer activists were lacking in many developing countries. Political parties favoring free markets had close ties to business, and thus had little incentive to promote consumer issues. Groups critical of the free market approach were often less interested in improving the market system than in replacing it altogether.

The experience of Chile, which led its neighbors in instituting market reforms, may be repeated in many

other Latin American countries in the near future. Chile returned to democratic rule in 1990, when a coalition of center and left parties came to office. The coalition was divided on the importance of the market mechanism in the economy—less along ideological lines than along generational lines. Younger politicians favored the free market approach, whereas older politicians preferred more government intervention. Although the market-oriented politicians prevailed, a significant proportion of the rank and file supporting the government yearned for more government intervention in the economy.

An anecdote told by the Bolivian undersecretary of commerce shows that this phenomenon is widespread. In 1993, when the governing party of Bolivia announced the establishment of consumer advice and redress offices throughout the country, the government received letters from elderly party members in the provinces, who offered their services to enforce price controls. Enforcing price controls was common work in Latin America in the 1960s, but it contradicted the essence of market reforms in Bolivia in the late 1980s.

Another illustration that governments are aware that the rank and file is still catching up on the spirit of recent reforms is implicit in a four-page pamphlet published by Chile's National Consumer Service (SERNAC). The pamphlet was designed to teach low-income housewives to compare prices, demand quality, check weights, ask for warranties, and so on.²³ It presents a dialogue between two housewives, one of whom argues that, since poor people consume little, they cannot benefit from consumer promotion policies.

In Chile, as in many other developing countries, no political group wants to push consumer issues as a priority. On the right of the political spectrum, close ties to business and skepticism of government regulations prevent the emergence of politicians who will fight for consumer protection. And those at the political center and left are fearful of fully embracing the market system. The first Latin American country to pass significant legislation favoring consumers was Mexico, a country in which the power of groups supporting radical alternatives to the system was never strong.

Once a consumer issue gains a place on the public agenda, however, few political groups are willing to invest political capital in opposing it. For this reason, many Latin American countries have recently enacted consumer protection laws and others are discussing their pros and cons. As market-oriented reforms begin improving consumers' well-being, politicians can be expected to embrace consumer issues.

How do consumer issues gain the attention of public policymakers? Consumer problems become consumer issues as a result of the interplay of the media, the public, and policymakers.²⁴ Policymakers sometimes pursue a consumer issue because they believe it is important, even if most consumers and the media are unaware of it. Other times policymakers react to public outcries after a disaster, as described in a film produced in 1984 by Consumers Union, *America at Risk*:

[There is] a pattern that seems to recur throughout the history of the consumer movement. First, there is a disaster, as in the case of the diseased meat and patent medicine scandals. Then there is research, investigations undertaken by scientists or by groups like the National Consumers League or by journalists to help expose the problem. Next there is a ground swell of protest by an outraged public, leading to a demand for legislation. Then a regulatory bill emerges, often so flawed by compromise that it takes another disaster and another struggle to get the bill amended.

Consumer issues emerge in a less unidirectional fashion than depicted in the Consumers Union film. In particular, there are clear limits to the ability of the press to lead public opinion on consumer issues. Their dependence on private advertising possibly explains why certain consumer issues are not covered by the media.²⁵ Much remains to be understood about how consumer issues reach, or fail to reach, policymakers' agendas.

Another question of interest is whether the problems that make it to the policy agenda are those that "should" make it. The approval process for new drugs illustrates an unfortunate asymmetry that may prevent policymakers from acting in the public interest. On the one hand is the risk of approving a drug that has dramatic side effects, such as the drug thalidomide. On the other hand are the costs of erring on the side of excessive caution by not approving drugs that could have benefited many people. In the second case, the threat of media exposure is smaller, since it is impossible to interview patients who died because a drug was not approved in time.²⁶ This asymmetry is likely to lead policymakers to be more cautious than is socially desirable when allowing new drugs to be marketed.

As developing countries consider consumer protection issues, they would do well to learn from other countries' mistakes. One such mistake was made in the United States in the mid-1980s. After scientists concluded that asbestos exposure contributed to thousands of cancer

deaths each year, the public outcry led the U.S. Congress to pass a law in 1985 requiring city and state governments to remove asbestos from public buildings at a total cost of \$15 to \$20 billion.²⁷ The Environmental Protection Agency concluded in 1990 that by releasing asbestos particles into the air, removal efforts had actually increased the health risk.²⁸ This example illustrates the danger of an overly reactive policy agenda.

Consumer protection in transition economies

Because most people in transition economies lack the basic skills needed to operate in a market economy, they are particularly vulnerable to fraudulent schemes. This section describes one such scheme, the MMM financial pyramid in Russia, and draws some conclusions for consumer protection policy.²⁹

MMM and its millions of shareholders

Millions of Russians believed that MMM, a little-known investment company that offered a 3,000 percent return on investment, could make their dreams come true. In early 1994, within only a few months, MMM sold millions of shares through 136 offices in 50 Russian cities (60 offices in Moscow alone). The price of MMM stock skyrocketed from 1,600 rubles (US\$1) in February to 115,000 rubles (US\$55) in late July.

The MMM investment fund was a classic financial pyramid scheme. Initially, MMM was able to sell a rapidly increasing number of shares and use part of the proceeds to buy back shares at a much higher price. Those who sold their MMM shares during this period received handsome returns, and these success stories attracted wide media attention. There was no warning that, as in any pyramid scheme, the throng of latecomer shareholders would be ruined when the pyramid collapsed.

On July 26 the Russian government disclosed that MMM's president, Sergei Mavrodi, was suspected of having violated tax laws. At month's end shares were quoted at only 1,000 rubles. All but one percent of the stock's value disappeared in a few days, and all but the Moscow office of MMM closed. By early August Mavrodi was in jail following a dramatic raid on his apartment by the tax police. Shortly thereafter, hundreds of thousands of panicking shareholders assembled in front of MMM offices in a frantic attempt to sell their shares. On August 4, MMM announced the temporary closing of all its offices.

The anticipated next chapter in the unfolding drama would seem to be that shareholders, realizing that they had fallen for a scam, would turn against MMM and Mavrodi, seeking restitution from a variety of legal and

other channels. What happened instead illustrates the different perspective required in addressing consumer protection issues in transition economies.

Mavrodi went on the offensive, accusing authorities of wanting to destroy millions of small capitalist shareholders. (Mavrodi claimed 10 million shareholders; outside estimates set the number at 2 to 5 million.) On July 29 he announced publicly, "We have been stopped on the eve of a super breakthrough, after which Russia could have become the richest country in the world, and Russians—MMM shareholders—wealthy people." Mavrodi succeeded in convincing MMM shareholders that the government was to blame, and a drive began to collect the requisite one million signatures to call a referendum to unseat the Russian president.

On August 22, MMM offices reopened and trading resumed. Incredibly, tens of thousands came not to sell their shares but to buy more. To bypass the legal requirement to register new shares, and to deceive consumers once again, MMM sold "tickets" rather than shares. The tickets were each sold for 1,515 rubles, on a vague promise that MMM would exchange 100 tickets for one share at an unspecified future date. In addition to trusting that this exchange would take place, ticket buyers were gambling that MMM shares would rise by a factor of more than 100, to a value exceeding 151,500 rubles—almost 40 percent higher than the peak value before the collapse.

Mavrodi's success in turning many shareholders against the state put the government on the defensive. Faced with shareholders' growing demands for restitution, Prime Minister Viktor Chernomydrin stated on July 30 that there would be no compensation to shareholders because any compensation would be at the expense of Russians who had not purchased MMM shares. Chernomydrin also acknowledged that the government had failed to enact appropriate legislation to prevent the fraud and placed the blame on the Ministry of Finance.

The ministry quickly drafted legislation to give the tax police regulatory control over all stock market transactions and allow the ministry to discriminate against foreign investment banks and institutions. Russian stockbrokers organized to block the legislation, which they feared would jeopardize market development. And the state privatization committee declared the proposed legislation an effort to turn off the taps of commerce and control the financial markets.

Mavrodi was elected to a vacant seat in the lower house of Parliament in a special election in October 1994. He thus gained immunity from prosecution on tax evasion charges. Although he had promised during his cam-

paign that he would save MMM if elected, he announced to the 3,000 supporters who gathered to celebrate his electoral victory the suspension of MMM shares. Shareholders thus had no hope of selling their securities.

Reasons for MMM's success. Today, several years after the dissolution of the Soviet Union, the state's desire and ability to protect individual economic rights and consumer rights is still viewed with suspicion.³⁰ Mavrodi cleverly capitalized on both this suspicion and the government's role as the social guarantor when he accused authorities of denying the Russian people the opportunity to become rich.³¹

The credibility gap faced by governments in transition economies puts them in a particularly difficult dilemma. On the one hand, governments must tread more carefully into consumer regulation than those in industrial countries. On the other hand, the state is still expected to come to the rescue of individuals in the name of social protection—even dishonest individuals like Mavrodi.

Another reason Mavrodi was able to bilk the Russian people is their market and economic illiteracy.³² Although some MMM shareholders understood that they were participating in a lottery, and that winning or losing depended on their sense of timing, the vast majority simply did not question whether there was a risk. Because MMM was the first pyramid scheme in Russia, Mavrodi, a brilliant mathematician and early learner of financial instruments, had more (and more accurate) information than buyers. Mavrodi knew that consumers would discover the quality of the good only when it was too late.³³

The worst threat Mavrodi perceived was limited bankruptcy (and perhaps a few weeks in jail), while he could still amass (and possibly hide) a small fortune. His potential gain far exceeded the risk. He may have even bet that the government would be forced to give the firm and its shareholders special treatment once the pyramid's fragility was exposed.³⁴

Mavrodi was also successful in reducing cognitive dissonance on a massive scale, that is, making shareholders disregard any negative views about MMM.³⁵ Shareholders wanted to believe that they were buying a ticket to wealth (see Akerlof and Dickens 1982). The belief was systematically nourished, night after night, by persuasive television ads. Once the pyramid began to crumble, shareholders quickly bought the argument that state intervention was to blame. By believing Mavrodi, they justified their decision to buy shares in the first place. Cognitive dissonance and consumer irrationality conspired in late August, when MMM tickets went on sale. One Russian, oblivious to the distinction between a share and a ticket, said while queu-

ing in the rain, "I believe in MMM and will buy five more shares. The instability is only temporary" (*International Herald Tribune*, August 23, 1994).³⁶

The combination of a credibility gap vis-à-vis the state, lack of consumer and economic education, and massive cognitive dissonance among an impoverished population dreaming of getting rich quickly only partly explains the success of the MMM scheme. Because Russia's market economy developed faster than the state's regulatory infrastructure, consumers were left unprotected and fell victim to Mavrodi's scheme.

The case against the "rational" incentive argument. One might argue that it was in the rational interests of shareholders to ally themselves with Mavrodi and demand restitution from the government, since their chances of recouping their investment from the second were greater than from the first once the pyramid collapsed. A rational incentive argument does not hold for two reasons. First, although shareholders might have been rational in turning against the government, doing so did not require them to ally themselves with Mavrodi. In fact such an alliance might have weakened government sympathy for shareholders.

Second, while Mavrodi was forging an alliance with shareholders as MMM was collapsing, the government was issuing warnings about MMM as well as a less-known but similar pyramid scheme, RDS. RDS executives were much more passive than Mavrodi had been in marketing MMM shares, and the RDS shareholders turned against the company. Mavrodi's personality seems to have made the difference.

Policy implications

The magnitude of the MMM scandal underlines the importance of putting in place an appropriate regulatory system. The challenge for the countries of the former Soviet Union is to do so without hampering their transition to a market economy. As they work to establish effective regulatory systems, countries must guard against overregulation. Clear guidelines on entry to the financial sector may well be all that is needed to safeguard consumers against future MMM-like schemes. Such guidelines would discourage unscrupulous operators and force legitimate entrepreneurs to provide full and complete information to the public regarding their products. Overzealous regulation, such as outright bans, may choke off bona fide operations. Pyramid schemes might be allowed so long as the public is aware that buying a share in such schemes carries significant risk. Furthermore, there is the clear need to enact and enforce advertising laws. Such laws would

require a scheme such as MMM to note in its ads that it is not an investment firm and that significant risk is involved.

The more general case of Ukraine's financial sector is also illustrative in this context. About 200 licensed banks operate in Ukraine, ranging from solvent Western-style banks to "treasury arms" of state enterprises to fly-by-night risk venture "capitalists." The central bank should clearly separate "real banks" from other financial institutions. The selected few core banks would have a specific set of duties and be subject to prudential regulation. They would receive a well-advertised seal of approval from central bank authorities. All others would be labeled as more risky financial institutions.

In addition, the creation of nongovernmental consumer advocacy organizations should be encouraged, since consumer groups can be very effective in increasing the responsiveness of the legal system to consumer problems. Consumer unions are becoming increasingly common in the countries of the former Soviet Union. In late 1993 the Consumer Society of Ekaterinburg sued Aeroflot after passengers encountered a 21-hour delay in a freezing Moscow departure lounge. Although no compensation was forthcoming as a result of the lawsuit, the mere fact that Aeroflot could be taken to court by consumers must be regarded as a landmark event.

Topics for future research

The development of effective consumer promotion programs and policies would be facilitated by research in several areas. First, studies of consumer complaints would assist governments in designing effective redress mechanisms. Such studies might address the following questions: What fraction of consumers express discontent with the products they purchase? What fraction of dissatisfied consumers complain to the seller? What fraction of complaints are resolved satisfactorily at this stage? How successful are consumers who take their cases to court or to an alternative dispute resolution mechanism? Research comparing the effectiveness of various legal redress mechanisms in promoting consumer protection is also needed.

A study of how consumer issues emerge in developing countries would also be useful. It might address the following questions: What is the role of the media in promoting consumer issues? To what extent are consumer issues promoted by policymakers? How do consumer advocacy groups emerge?

Most developing countries do not have a tradition of evaluating public policies and debating the resulting conclusions. When various policies are considered to address

consumer issues, there is rarely even a preliminary quantification of costs and benefits of the alternatives. Available studies have been often sponsored by institutions with a vested interest in the issue at stake.

It is important to educate the public on the fact that consumer protection policies involve costs and benefits, and that their effectiveness should be ascertained. Just as indices have been developed to measure the effectiveness of antitrust policy, for example, it would be useful to develop indices that quantify the effectiveness of consumer protection policies in selected countries.

In addition, a study of public and private consumer organizations is needed to answer the following questions: What are the critical elements for a successful organization? What organizational structure is most effective? What relationship should such organizations forge with government agencies and business organizations?

A final research question is, at what stage during the transition to a market system should consumer protection become a priority? Documenting the emergence of consumer issues and groups during the reform in the countries of the former Soviet Union would be instructive.

Conclusions

The degree to which consumers are protected depends on the combined effect of policies and institutions. A given degree of protection can be achieved at similar costs with very different combinations of policy instruments. It follows that a holistic approach is called for when designing consumer policies.³⁷

In most developing countries, consumers' access to redress is severely limited. Not only is obtaining redress through the legal system expensive; the system often functions poorly or is even corrupt. Any strategy aimed at improving consumers' access to redress should be three-pronged: First, it should include vehicles to facilitate consumers' access to legal redress, such as small claims courts, and mechanisms for collective action, such as class action suits; second, it should include alternative dispute resolution systems, such as arbitration by public consumer organizations; and third, it should seek to increase consumer understanding of available redress by promoting consumer education in primary and secondary schools.

Laws that make using seatbelts mandatory, require cooling-off periods for door-to-door sales, and mandate health warnings on cigarette packages all would be unnecessary if consumers were "rational." Policies that rely on consumer rationality may be expected to be less effective in practice than those that begin with the understanding that consumers often do not act rationally.

In an open economy, producers also stand to gain from strong consumer protection policies. As consumer protection develops, consumers become more assertive in voicing complaints about low-quality goods and services.

Consumer complaints are a source of information that businesses can use as a valuable competitive tool. More demanding consumers provide a market where potential exports to industrial economies can be tested, thereby guaranteeing a minimum return on new, risky investments.

Consumer organizations can play an important role in developing and industrial countries alike. They can educate consumers about products in the marketplace, monitor the safety and effectiveness of products, act as arbitrators, provide quality certification, conduct product testing, and represent consumers before government agencies and legislative bodies. Consumer education, in particular, plays a central role in any strategy to protect consumers. Knowing how markets work, how to use resources efficiently, and how to obtain redress helps citizens achieve higher living standards and helps markets function more efficiently. If a consumer organization is created as a government agency, as in most developing countries, it should be designed to foster rather than hinder the emergence of private alternatives.

Notes

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1. Of course, information on health and safety is beneficial to consumers in both rural and urban societies.
2. Some tentative explanations of why this has not happened in most industrializing countries is offered later.
3. For example, the French government allocates 24 minutes of prime-time television a week to its consumer organization.
4. See Baecher 1988 for details.
5. The following discussion is based on Adler and Pittle 1984.
6. Australia was the first country to enact a mandatory seatbelt law in 1972. New Zealand, France, Puerto Rico, Sweden, Belgium, the Netherlands, Israel, Finland, and Norway followed in less than four years. See Mayer 1989.
7. The tension between fairness and cost-effectiveness is present here. Insuring consumers against the entire set of risks they face achieves the purpose of compensation in an efficient manner but

breaks the link between compensation and seller responsibility. Ultimately, it must be recognized that one of the objectives of consumer policy, especially in developing countries that have recently undergone market-oriented reforms, is that citizens perceive the market system as fair; direct redress mechanisms are more effective in achieving this objective than is insurance.

8. The following countries were included in the study: Canada, Denmark, England, France, Germany, Netherlands, Norway, and Sweden. See Pirie 1987, Goldberg, Green, and Sander 1985, and Graver 1987. A study by Vargas (1989) in Tijuana, Mexico, had similar results.

9. Vidmar (1988) found that the likelihood that a consumer will pursue a problem grows with the monetary value involved. This does not contradict another finding by the same author that since producers also may be expected to spend more resources on winning their case as the monetary value involved grows, the likelihood that a consumer obtains redress decreases with the monetary value involved.

10. The discussion that follows draws on Forte 1991 and Graver 1987.

11. Although private organizations are better suited for this task, they often do not exist in developing countries.

12. For a discussion of search and experience goods, see chapter 6 of this volume.

13. Growing provincial involvement in the field of consumer affairs contributed to the program's demise in the early 1980s.

14. In the 1930s, fearful that it would offend its advertisers, the *New York Times* refused to carry the Consumer Union's paid advertisements. See Morse 1981.

15. Of course Brazilian taxpayers ultimately bear these costs. But given the public good nature of the collective action being induced, this may be precisely what is called for. The Brazilian law also allows the government to bring a case to court when collective or diffuse interests are at stake.

16. It is remarkable to find common law principles in a country with a legal tradition rooted in civil law principles. This finding may be an indication that common law is better suited to handling consumer grievances than civil law.

17. The General Agreement on Tariffs and Trade (GATT) approved an agreement advocating international standardization as part of the Tokyo Round.

18. See International Standards Organization, *ISO Bulletin*, February 1993.

19. The latter no longer holds when countries differ significantly in their quality and safety requirements, which often is the situation for countries with large income differences. In this case increasing the standards in the less-developed country makes local goods better but more expensive.

20. The discussion that follows draws on Reich 1988.

21. Even if government agencies lack the administrative skills to protect consumers, this does not necessarily justify banning imports of certain dangerous goods. Such bans are justified only if market

forces provide more incentives for local producers to consider safety issues than are provided to foreign producers.

22. The market failure underlying manufacturers' lack of interest in providing safety was market power.

23. See "Cualquiera... No da lo mismo!," SERNAC 1992.

24. What follows is based on Mayer 1991, which applies issue emergence analysis to consumer issues.

25. See Rowse 1967.

26. In recent years certain groups of patients, such as those with HIV-AIDS, have organized to lower the requirements for the release of new drugs. The high costs of organizing such a lobby justify describing the situation as asymmetric, even in this case.

27. See Breyer 1993 and the series of articles published in the *New York Times* between March 21, 1993, and March 26, 1993.

28. In 1991 asbestos-related cases represented more than half of all cases before U.S. federal courts (see Viscusi 1991, p. 7), contributing to the near-bankruptcy of Lloyds of London.

29. This section relies on *the Economist*, the *Financial Times*, and the *International Herald Tribune* (various issues, July 25–August 23, 1994). Conversations with Charles Blitzer of the World Bank's Moscow office and Chrystia Freeland of the *Financial Times* are also gratefully acknowledged.

30. One of the most experienced foreign journalists on the scene, John Lloyd, began an article in the *Financial Times* (July 26, 1994) by stating, "The threatened collapse [of MMM] is pitting the newly awakened forces of consumerism against the widely distrusted Russian authorities. . . ."

31. *The Economist* (July 30, 1994) wrote that Mavrodi was trying to blackmail the government into bailing out shareholders. In a letter to the tax agency, Mavrodi warned that his paying the 50 billion rubles in unpaid taxes and fines that the agency claimed he owed would destroy MMM: "I will not forecast what shape the anger of the robbed people will take: a revolution, civil war or something else."

32. During the Soviet era there was an informal, illicit economy in which many ingenious transactions took place. Those "entrepreneurs" have had a head start in the official transition to a market economy and have rapidly amassed wealth through their relative monopoly on "market education."

33. See chapter 6 for a discussion of credence goods, which consumers must buy on pure faith.

34. There existed a literal as well as a figurative moral hazard problem: The extent to which the costs of Mavrodi's recklessness would be borne by others became larger the more widespread the deceit, since this increased his perceived blackmailing power.

35. See chapter 6 for a discussion of cognitive dissonance.

36. Also suggestive of the existence and extent of cognitive dissonance are the disparate beliefs of shareholders and nonshareholders. Whereas shareholders by and large blamed the government for what happened, a poll of Muscovites by the Institute of Sociology revealed that 25 percent blamed MMM, 21 percent blamed the

"gullibility and naiveté" of shareholders, and only 13 percent blamed the government and the taxation service.

37. The Japanese consumer policy framework is famous for following such an approach. See McGregor 1991.

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