The "Economic Cost of Dishonesty"…

The difficulty of distinguishing good quality from bad is inherent in the business world…

As a result, there tends to be a reduction in the average quality and also in the size of the market…

The Market for "Lemons"

George A. Akerlof

This is the first in a series of my articles on business lessons in economics inspired by a series of economic briefs in the Economist published in 2016.

The Link

Business people often come across the situation where the client will only buy their product if they are able to match the price of an inferior competitor product because it is so much cheaper. And with much regret, you just have to walk away from the deal. Sometimes, you end up introducing a comparable cheaper product just to compete, which eventually leads to the discontinuation of the original superior product, even though you know this is not in the client's or the markets interests. In a sense, although a bit more complex, that is what Akerlof's *The Market for "Lemons"* is about. It's an inability to counter misinformation and illusory perceptions. However, in the majority of cases in business, this can be significantly alleviated with a little common sense, foresight and planning.

The Lost

Almost 50 years ago, the very astute economist, George A. Akerlof, wrote a paper titled The Market for "Lemons": Quality Uncertainty and the Market Mechanism. A "Lemon" being the American slang for a car that is found to be defective only after it has been purchased. In his now famous example of the used car market, he demonstrates how a lack of accurate information distorts and disrupts the market place often to the detriment of both the sellers and the buyers. His principal determination being the "*Economic Cost of Dishonesty"* which he attributes to 'information asymmetry' or in other words, information is known to one side but not the other. In his paper he also illustrates this principle in relation to the insurance, employment and credit markets but clearly the principles can be applied across many markets. He concludes that *the difficulty of distinguishing good quality from bad is inherent in the business world*. But importantly, he points out that there are ways to counteract these distortions primarily by addressing the "trust" deficiencies.

Without thinking too literally about it, put in simple terms, Akerlof outlines a scenario whereby the used car market consists of dubious junk (Lemons) valued at $500 and well maintained vehicles (Peaches) valued at $1,000. The problem is that with a small amount of effort and a bit of vagueness, a Lemon can start to look like a Peach and in a lot of cases, you are not going to find out what it is until after you have bought it. There are usually several net effects of this ambiguity.

1. Buyers know that this can go either way so they offer $750 and hope that they get a Peach instead of a Lemon.
2. The only Sellers prepared to accept $750 are the ones off-loading the Lemons.
3. Smart Buyers only offer $500 because they know this is the true value of a Lemon and therefore they cannot lose.
4. Sellers are happy to accept the $500 because that is the true value of the Lemon.

5. Despite there being Buyers happy to pay $1,000 for a Peach, they will not take the risk of ending up with a Lemon so the Peaches remain unsold.
6. Sellers of the Peaches eventually withdraw from the market.
7. There is a race to the bottom with ever cheaper and more dubious Lemons.

Although there are a number of ways of interpreting and applying Akerlof's theory, what it establishes, is that where there is a failure to communicate information, whether deliberate or accidental, there is a cost to the Buyer, the Seller or both.

The Lesson

We can all identify with some or all of Akerlof's principles. But let us be honest, these vagaries in the commercial world are not necessarily dishonesty, but what we like to call commercial or competitive advantage, without a degree of which, many products and businesses eventually fail.

Now that we have linked the economic or commercial costs with information advantage or communication failure, the question is when was the last time you gave serious consideration to ensuring that the optimum commercial information about your product or service was effectively communicated to your customers? Or, when was the last time you strategically reviewed a product's place in an ever-evolving market place? I am sure that for many of you the answer is 'often but not recently' and *The Market for "Lemons"* will now stick in your mind and serve to remind you of the critical discipline called Information Economics***.***

Competitive Advantage

In the first instance, competitive advantage is making sure your product or service is placed where it cannot be undermined and the Business Dictionary definition is:-

> *A superiority gained by an organization when it can provide the same value as its competitors but at a lower price [Comparative advantage], or can charge higher prices by providing greater value through differentiation [Differential advantage].*
> ***Competitive advantage results from matching core competencies to the opportunities.***
> More…

A lot of people ask me whether there is a simple model for competitive advantage and my response is that, although it is often the greatest weakness or failure of many businesses, the answer is competent research and effective marketing. One of my first questions to any business is "What is your Marketing budget?" or "What percentage of your revenues do you spend on Marketing?" The ability to answer, is the answer to my question.

If you can provide the same product as your competitors at a lower price (Comparative advantage), then well done, but be warned because in most cases, it is only a matter of time before your advantage and margins are eroded. If you want sustainability and optimum profitability, then you are looking for Differential advantage, which is quite simple really.

Uncomplicated marketing

First you must understand the market place and your product or service's place in that market place. Markets change constantly and there is no substitute for regular market research. "Who is going to do that?" I hear you ask. Well you will be surprised by how much you already know, you just need to open your mind and structure your analysis. When you have done your research, you are at liberty to use a bit of poetic licence but the golden rule is, do not describe your Mondeo as a Rolls Royce, they always find out the truth. It is imperative that you communicate ALL of the positive attributes of your product. In a competitive world, you might want to enhance those attributes with things like special warranties, which you can sometimes insure against, or periodic promotional activity. The list of options is almost endless. Engagement above and beyond the product or service is the key to success. Find cost effective communication channels and I do not mean traditional adverts. **Never** underestimate the value of PR. The list of enhancing attributes is only constrained by your imagination; your time, or the depth of your pockets. The Economist George Akerlof calls these activities 'Counteracting Institutions'. I call them common sense and Marketing and they all compound to create that most powerful of business tools, The Brand, which even an Economist like Akerlof understood.

The Product

Before we say a few words about The Brand, let us just think about a product. Imagine a simple white coffee mug for sale on eBay. It looks quite nice, functional and you can buy it for £3.99. Now imagine another simple white coffee mug on Amazon. It is described as elegant with a special glaze that gives off a slight iridescence. The handle is ergonomically shaped and the lip is slightly curved to enhance the ease of use and experience. You can buy it for £5.99. Some people will realise that they are the same coffee mug and yet many more will be purchased from Amazon. This does happen. It is called commercial optimisation using marketing.

The Brand

When most people think of a brand they think of Coca-Cola or Kellogs or BP. Although there are some very sophisticated definitions of what a brand is, they basically represent products that people identify and feel comfortable with. Many years ago, I lived in a medium sized town and there was this tiny shop by the Fire Station called Khan's. It was the only place open late and on a Sunday morning and it seemed you could buy anything there. It was rammed full with products and people and you did not know the price till you paid for it. Everyone seemed to know the name Khan's. In a sense, it had all the prerequisites to be a brand. Brands do not have to be big or international, they just need to have a successful identity. This varies with the nature of the product but will only result from understanding the market, placing the product or service correctly and communicating effectively.

See Branding - https://www.entrepreneur.com/encyclopedia/branding

The content of this supplemental analysis is not definitive or exhaustive. That is your Marketing teams job.

The Summary

In the paper, *The Market for "Lemons",* the Economist George Akerlof, demonstrates mathematically the net costs of asymmetrical information which is now universally acclaimed and earnt him a Nobel prize. Although he uses some specific examples such as used cars; employment; insurance and credit markets, the broader principles of the negative effects of information failure can be applied across almost any market. Although his paper was produced to demonstrate an economic principle, or perhaps to debunk some traditional economic principles, it raises a number of important issues relating to commerce, such as the difficulty of distinguishing good quality products and services from bad, which is inherent in the business world, or perhaps more significantly, the failure of so many in business to recognise the costs.

So the lesson is quite simple, in order to maximise revenues and returns from every product or service, they must not be undermined in any way. Are you happy that you are successfully communicating the true value of all of your products or services?

If you would like to get your head around Akerlof's *The Market for "Lemons"* a bit more try this 2-minute visual representation on YouTube, Information gaps - asymmetry

Or for an excellent 2 page summary and interpretation try the Economist article, Secrets and Agents.

Or if you are really interested in the broader concepts you can download a copy of Akerlof's paper Unless you are an economist, skip over the 2 pages of math. It is not a hard read for the average business person and can be very insightful.

William David @ http://www.williamdavid.me.uk/business-economics/

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