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**.**

If you feel like refreshing your views on Competitive Advantage, then follow this link for a brief marketing synopsis to the problem of product or service communication shortcomings.

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 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.

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