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QUALITY ASPECTS OF ECONOMIC TRANSITION: THE EFFECT OF INFERIOR QUALITY ON THE MARKET

The present paper explores the quality problem as a major challenge before transitional economies. It uses Akerlof's model of misrepresented quality in an attempt to study it as the reason for market failure in the new democracies. The determinants of poor quality in the region of Eastern Europe are presented and the role of opportunism as the major cause of deceptive quality is revealed in the context of the staggering transaction costs East European countries are faced with[2]*. Reputation and the costs of dishonesty for East European producers are discussed.*
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In his phenomenal article "The Market for "Lemons": Quality Uncertainty and the Market Mechanism" Akerlof (1970) discusses the presence of asymmetric information and inferior quality as the reasons for the disappearance of certain markets. The example given is rather narrow, that of used automobiles whether good ("peaches") or bad ("lemons"), that can be transferred to other markets and spheres of economic life. This paper aims to study the effect of product quality on the development and stability of transitional markets in East European countries. Undergoing the process of restructuring, nearly all post-communist countries experience the problem of deteriorated or bad quality of products, both industrial and consumer goods, which affects the functioning of their markets.

Akerlof's finding is somewhat surprising: inferior quality products would invariably replace good products and he draws an analogy with Gresham's law of money. He maintains that this analogy is not complete as in Gresham's law bad money would drive out good money but both sellers and buyers can tell the difference between them. On the market for used cars, however, the sellers have more information about the quality of the cars they are selling than the buyers. Since buyers cannot tell the difference, both good and bad cars sell at the same price. Akerlof's conclusion is as follows (1970, 495):

> *"The presence of people in the market who are willing to offer inferior goods tends to drive the market out of existence - as in the case of our automobile "lemons." It is this possibility that represents the major costs of dishonesty – for dishonest dealings tend to drive honest dealings out of the market. There may be potential buyers of good quality products and there may be potential sellers of such products in the appropriate price range; however, the*

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[1] *Tamara Todorova is ....*

[2] The early treatment of the term "Eastern Europe" provided in international economic reviews before 2000 involves the countries of Central and Eastern Europe which have also been seen as the opponent of the western capitalist system. This concept has later been expanded to the Baltic states (Economic Survey of Europe 2003 No 1 and 2004 No 1).

presence of people who wish to pawn bad wares as good wares tends to drive out the legitimate business."

The outcome of having goods of inferior quality sold as superior products is that only the former would be offered. Thus, demand may turn out to be insufficient to meet the supply of such lemon goods, ultimately causing the collapse of the market. It is this effect of inferior quality products that the present paper aims to study in the context of newly emerging markets in Eastern Europe.

The Origin of the Quality Problem

The roots of the quality problem may be traced to past times, those of socialism when quality was the object of control of the central planning committee. Information asymmetries existed even in those days when the party-elected managers acted as agents of the state that did not have the full information. Arrow (1985, 39) describes the role of the socialist state as the principal in the following terms:

"Because the knowledge of productivity cannot be centralized, the individual productive units have information about the possibilities of production not available to the central planning unit. The productive units may well have the incentives not to reveal their full potentiality, because it will be easier to operate with less taxing requirements. The problem for the central planning unit (the principal) is how to tap the agent's information. A similar problem occurs in decentralization within a firm."

The case is one of both hidden information and hidden action on the part of socialist managers when in the first case the agent has acquired some information that the principal does not have or, as in the second case, the effort level of the agent is unobservable by the principal. Quality problems resulted from both types of asymmetries. The managers of socialist enterprises would not disclose to the high party officials the truth about the quality of the products produced, nor would they strive for improved quality. The goal of the socialist agent, like that of nearly every agent, was not to work toward the goals of the principal, i.e. the socialist state, but rather to his own goals.

In a remarkable paper titled "Why Economic Reforms Fail in the Soviet System: a Property Rights-based Approach?" Winiecky (1996, 65) explains various ways in which socialist managers have tried to achieve their own goal, that of "maximizing their rents." While he does not specifically study quality, rent-maximization efforts affect it the most. Soviet-type managers did not try to increase the value of their firms by means of product quality and reputation or other mechanisms available. Quality considerations were perhaps the least important. In their attempts to maximize their own utility managers struggled to remain at their positions and extract benefits by sacrificing quality for quantity. An efficient way to do that was to supply wrong information to the higher nomenclature, always more favorable than the actual results. The state officials would not have adequate means of verifying the supplied information and would have to take it for granted. On the other hand, the state's stress on extensive rather than intensive methods of production put the focus on quantity more strongly than on quality. As a result, managers overstated the achievements in the production process and the fulfillment of the five-year plan in quantity terms, completely ignoring the quality aspects of this process. Whenever quality was reported, data would be seriously exaggerated because of the difficulty to check actual quality levels. Informational asymmetries in socialism were thus most visible in the case of product quality where product nonconformance to standards was most difficult to detect.

At the same time the socialist economic system was one that could not properly measure the individual contribution of each worker within the production unit. This created incentives for free riding in socialist organizations which ultimately undermined quality[3]. According to Simon (1991, 33) “where output quantities are measured with inadequate attention to quality, response to rewards will cause quantities to grow at the cost of lowered quality.” It was at the heart of socialist firms to rely on “the collective” where quality attributes of personal achievement could not always be measured with precision or were ignored. The collective way of producing allowed free riding on the efforts of other members and quality was thus the weakest area of socialist production.

The Soviet-type economic system demanded more and more “goods for the people” and this was frequently achieved at the expense of quality. The concept of quality, therefore, was missing in the mind of the average citizen, who more often than not expected to get a mediocre product in the store. It is from this system that the attitude to quality originates and prevails in modern days. The historical approach that modern institutionalists take to economic development reveals that the contemporary quality problems in transitional economic systems originate from the past. In his theory of path dependence North (1990) concludes that it is more difficult to change informal rules such as habits and customs established in society and human mentality with time than to change the formal institutional setting. Following North’s logic, we can conclude that it is the attitude to product quality and performance citizens of Eastern Europe inherit from their past that would set the future of local markets.

Some General Quality Considerations

An observant investigator of product quality will discover it is mostly lemon goods that are produced and traded in East European markets at present. While there are exceptions to this rule, it does not take long for a westerner coming to the region to realize the discrepancy between the quality of local products and those made in developed industrial countries. Quality is an outstanding problem for transitional economies struggling to find a market niche in the global economic system. This aspect of East European goods hinders their global competitiveness. Quality and quality considerations quite often turn out to be a natural “barrier-to-trade,” uninspired by any state or supranational authority. In their efforts to expand exports and solve trade balance deficits governments in the region struggle to find core industries and activities that can provide them with a competitive edge. However, when the issue of quality comes up, all those governments face the bitter reluctance of developed countries to import their goods and disputes over quality and grading break out. Poor quality is given as the main reason for blocking trade with the East. As a general rule European Union officials refer to the

[3] This was most apparent with the so called “brigade principle” that prevailed even at the time of “perestroika.” The principle measured “team” results rather than individual effort. The brigade usually had its own code of ethics and except for individual productivity it decided on the personal lives and morale of the workers. The most senior worker would most often be the chief of the brigade and would generally be party-approved.

nonconformance of East European products to EU standards, and the transitional economies seem to be losing the trade battle[4].

Domestically the problem of inferior quality is even more dramatic. While the conviction that buying "local" can help boost the economy is commonly shared, few individuals do, indeed, buy home-made or country-produced goods. Irrespective of the price of the products on the market for high-tech goods, for instance, consumers prefer western or Asian-made brands and intentionally avoid domestic production, the reason obviously being the superior quality of foreign brands incomparable to local ones. It can be concluded that East European consumers are, in general, quality conscious and have higher reservation prices for superior quality goods, but very often those are not available to them.[5] The more technologically advanced the product or product group, the more severe the problem gets. The more technology-intensive the good, the more willing people are to substitute it with a western brand.

A similar case exists in the sphere of services and business partnerships. Quite frequently local companies prefer contracting with foreign firms to contracting with a firm at "an-arms-reach". This is not only because of the wider range of services[6] usually provided by western companies but mostly due to the lack of opportunism or the true quality of their services. In business dealings many East Europeans prefer western partners simply because they expect less opportunism than when choosing locals.[7]

Determinants of Inferior Quality

There are new dimensions to the systemic quality problem that existed in the socialist past and that has been transferred onto the present through the mechanism of path dependence. Partly the problem has been alleviated by the move to capitalism and the market. There is clearly a stronger orientation to quality as the inevitable result of the interplay of market forces and competition. Firms find it more and more pressing to adopt innovative marketing approaches focused on the customer and his satisfaction. It becomes advantageous to improve product features in order to stay ahead of local and foreign competition. Still, the problem of sub-optimal quality persists as part of the economic reality in transitional countries. Some of the factors contributing to this will be studied further in view of the relevance of Akerlof's model to post-communist economies at the present moment.

One essential determinant of inferior quality is the opportunism in seller-buyer relationships in the local commercial culture. It is hard to speak of any "market culture" at all in the way modern economics defines it, as it was absent in the conditions of a market vacuum. A market philosophy is missing in the mindset of

[4] Inferior quality turns out to be an elegant means for blocking trade. Whenever EU countries face direct threat from East European products and wish to prevent their imports, they refer to the quality clause.

[5] It is worth noting that improving quality increases demand. Higher reservation prices in return for better quality simply imply a rightward shift of the demand curve because, given better quality, consumers would opt to buy more of the good at the same price level. Thus, improved quality can actually stimulate demand which is particularly important for East European markets.

[6] An example of that is the banking sector. Foreign banks in Bulgaria are known to provide a much greater variety of services and to be much more efficient. Their operations extend globally, on which Bulgarian banks cannot fully compete.

[7] It may very well be that the firm deliberately tries to mislead a western partner which demonstrates the high degree of opportunism existing in the region.

the East European, who does not seem to be clear on how business is done, what the market does and how property should be handled. Being propertyless, citizens of young democracies cannot find their place in the market system. In support of this Riker and Weimer (1995, 94) point out that "there does not seem to be a broad and deep understanding of the role of private property in market economies".[8] The two authors quote David Mason (1992) who found that "majorities of residents of the post-communist countries supported values and policies associated with the socialist system, even though large majorities also expressed disfavor toward socialism."

The market mechanism is an enigma to the individual who plays the role of a subjective factor in the process of exchange. It turns out that human nature "as we know it," impacts the outcome of a contractual arrangement while one or all parties to a contract may be excessively opportunistic. East Europeans are no less opportunistic than any other economic agents in the world and human "selfishness" is a factor shaping product quality in the markets all over Eastern Europe.

Opportunism in Seller-buyer Relationships in Eastern Europe: The Subjective Factor

Oliver Williamson (1985, 47) contends that human beings are "self-interest seeking with guile." Studying the contractual behavior of man he concludes that the economic man is one of intended but bounded rationality, who experiences a strong form of self-interest seeking. This strong form, or opportunism, is one of the primary characteristic features of contractual relationships in Eastern Europe. Moreover, opportunism is particularly strong in the post-communist world due to the legacy of communism, the system of blurred property rights and the nurturing of such deviant behavior in individuals by the socialist state. For example, common property was considered nobody's property; there was an extreme tendency toward overusing economic resources and free ride.

Today pre-contractual and post-contractual opportunism is present at every stage of the transaction process and the transaction costs resulting from asymmetric information, moral hazard and shirking are incredibly high. In various markets there are people who deliberately sell low quality goods as standard quality goods. According to Akerlof such trade practices would have devastating effects on the market. In his model demand depends on quality as well as on the price of the product. Information is asymmetric only to the point of purchase. After that the consumer has all the information and a good idea of the quality of the good, in his example the used cars purchased.[9]

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[8] As quoted by Furubotn and Richter (2000).

[9] It should be noted that Akerlof's analysis applies to experience goods and credence goods perhaps more strongly than to search goods. With experience goods the consumer acquires knowledge after testing and experiencing the good (Church and Ware 2000). With credence goods the consumer is not able to judge the quality because it is a highly sophisticated product or service he consumes of which he knows nothing. It is necessary for an expert to evaluate the quality of the good. An example of this is a patient who goes to the doctor and is prescribed a medicine. The patient himself is unable to decide whether it is a good or a bad drug. There must be an expert to make the judgement for him. Finally, with search goods consumers know well the features, functions and quality of the respective product, which they often buy on an everyday basis. Most commodities in a convenience store purchased daily represent such search goods. According to Church and Ware (2000, 184) "consumers are not always badly informed before purchase… Economists call such goods search goods." Naturally, a producer will

Suppose that a consumer experiences utility U_g from a good car and U_l from a "lemon" and the probability of buying a "lemon" is π ($0 < \pi < 1$). The equilibrium price of new cars must be lower than the expected utility of buying a car that may be good with a probability $1-\pi$ or bad with a probability π. We must have:

$$p_n \le (1-\pi)U_g + \pi U_l \qquad (1)$$

where p_n is the price of new cars. If p_u is the price of used cars, it must be lower than that of new cars, or $p_n > p_u$.

The owner of a good used car will be willing to sell it only if the price obtainable by selling it exceeds the utility of using it, that is as long as:

$$p_u > U_g \qquad (2)$$

By transforming (1) we obtain:

$$U_g \ge p_n + \pi(U_g - U_l)$$

Since the utility of a good car is greater than that of a lemon, the parenthesized expression is strictly positive and from (2) it follows that $p_u > U_g \ge p_n$. This is clearly in contradiction with reality ($p_n > p_u$) and equilibrium in the used car market is possible only when lemons are sold. This may lead the market to fail.

In terms of the market equilibrium the problem may be expressed in the following way. Let the demand function be:

$$D = D[p, \kappa(p)]$$

where p is the price of the used car and κ is the average level of its quality. Average quality $\kappa = \kappa(p)$ is a function of price as well. As the price falls, quality is expected to fall, too. We get the following partial derivatives:

$$D_1 = \frac{\partial D}{\partial p} < 0 \qquad D_2 = \frac{\partial D}{\partial \kappa} > 0 \qquad \kappa' = \frac{\partial \kappa}{\partial p} > 0$$

At the equilibrium supply must equal demand for the average quality and we should have:

$$S(p) = D[p, \kappa(p)]$$

However, under certain conditions the effect of quality may outweigh that of price. Differentiating D with respect to p totally, we get:

$$\frac{dD}{dp} = \frac{\partial D}{\partial p} + \frac{\partial D}{\partial \kappa}\frac{\partial \kappa}{\partial p}$$

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always be tempted to lower quality independent of the type of the product. However, consumers know some goods better than others. Except for the product characteristics, this may as well depend on the frequency of purchase and the firm's reputation. A firm that has established its reputation will be less likely to "cheat" on its traditional customers in return for some short-term benefits. The fact that consumers know some commodities better increases the costs of cheating on those markets. Therefore, it can be expected that producers of search goods would be less likely to cheat by degrading quality.

Thus, the total effect of price on demand may be positive causing a positively sloped demand curve. Being asymmetrically informed consumers expect sellers to reduce quality and the market is led into a low-quality equilibrium where firms provide low quality and consumers expect it. Demand for the good may be insufficient to meet supply and actual market equilibrium may not be achieved. The market, then, would be driven out of existence according to Akerlof.

But the same result could occur in the case of Giffen goods for which the demand curve has a positive slope. Optimal demand for a Giffen good decreases when its price falls[10]. In contradiction with the basic law of demand the rising slope of the demand curve may not allow for a market equilibrium to be achieved leading to a market failure in a similar mode as "lemons."

It is quite possible, Akerlof (1970, 490) says, that no goods be traded at any price level:

> *"For it is quite possible to have the bad driving out the not-so-bad driving out the medium driving out the not-so-good driving out the good in such a sequence of events that no market exists at all."*

The fact that lemon goods are sold in Eastern Europe helps explain the lack of developed, well functioning markets in the region. Quality is clearly a factor for market failure that needs to be studied in depth in the case of transitional economies. In connection to this is Arrow's statement (1969, 48) on market failures:

> *"Current writing has helped bring out the point that market failure is not absolute; it is better to consider a broader category, that of transaction costs, which in general impede and in particular cases completely block the formation of markets. It is usually, though not always, emphasized that transaction costs are the costs of running the economic system… The identification of transaction costs in different contexts and under different systems of resource allocation should be a major item on the research agenda of the theory of public goods and indeed of the theory of resource allocation in general."*

Misrepresented product quality necessarily comes with opportunism and high transaction costs in business dealings. Cheaters who push inferior goods on the markets for "superior" products do not realize the effect they have on those markets. Being overly rational and seeking self-interest, they bring market transaction costs so high that the absolute lack of trust and the enormous degree of risk and uncertainty exceed greatly the gains from the transaction making it unprofitable. The role of ethical and moral codes in the process of exchange is crucial and Arrow (1969, 62) continues:

> *"I want, however, to conclude by drawing attention to a less visible form of social action: norm of social behavior, including ethical and moral codes… It is useful for individuals to have some trust in each other's word. In the absence of trust, it would become very costly to arrange for alternative sanctions and guarantees, and many opportunities deriving from mutually beneficial cooperation would have to be forgone. Banfield (1958) has argued*

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[10] As defined by Varian (1996, 104). He maintains that Giffen goods are "so rarely observed in real life" and are not only inferior, but very inferior (Varian 1996, 143).

that lack of trust is indeed one of the causes of economic underdevelopment."

The concept of business ethics is entirely missing in the newly-emerging markets, which are often seen as a game with "predatory" rules or no rules. The market economy in its turn is perceived as a "jungle" without order where all means are allowed. Market institutions as the rules of the game are rudimentary, if present at all. They are often viewed as unnecessary. The market to many is a chaotic mechanism that, following the classical view, would clear itself without any intervention. Many post-communist countries have now moved from one extreme to the other - from an entirely centrally controlled economic system to a plundering capitalism. Lacking any rules from the past, having neither prior experience, nor market tradition, countries find it an impossible task to build up developed markets from scratch. The presence of so many people deflating markets in the region and the high level of opportunism in economic exchanges, much higher than that in other countries and cultures, can explain the collapse of East European markets. Quality is a possible explanation for market failure in the otherwise market-headed post-communist societies. Developed or advancing markets in the region are still missing while impediments to trade are countless. Opportunism, deeply rooted in those societies, one of informational asymmetries and distortions, of indivisible property rights, of lacking market institutions, and of proper trade practices, is a major cause of market failure.

Systemic Quality Problems in East European Economies: The Objective Factor

While human behavior as the source of opportunism is the subjective factor for deceptive quality, there are some other quality determinants that may be considered independent of individual action. A second group of factors, rather objective in their nature, are some systemic economic problems that erode product quality. The nonbehavioral factors in the economic environment that contribute to low quality will be reviewed next.

According to Fairbanks and Lindsay (1997, 12) in factor-driven economies with legacies of protectionist policies firms make choices driven by comparative advantages. They compete in areas where cheap raw materials, labor or transportation costs appear to provide an advantage over competition. But in search of a competitive edge producers may fail to provide value to customers by not responding to their evolving needs continuously or not meeting their quality requirements. Bulgarian producers have been unable to deliver acceptable levels of value over the past several years (Dimitrov, 2000)[11].

Western authors emphasize the poor product quality across the entire region of Eastern Europe. Amsden (1997, 56) quotes World Bank and International Monetary Fund reports in that "improving the quality of products has to be a top priority item" in the pulp and paper industry; that the textile industry throughout the region needed time to boost the attractiveness of its fabrics; that leading Hungarian metalworking firms required foreign licenses to upgrade their production know-how; and that the Russian military-industrial complex had to retool if it hoped to make consumer electronics and other durable goods." In her study of 20 state-owned

[11] The author maintains that this is his personal view based on secondary information sources and interviews.

enterprises in Hungary and Poland in 1991-1992 Amsden discovered how "poorly run and uncompetitive" some East European companies were and that "these enterprises certainly employed more workers than they needed for efficient production …" She considers the real problems to be outdated technology and poor product quality.

There is an obvious move away from capital- or technology-intensive production towards labour-intensive one, part of it due to the abundance of cheap and relatively skilled labor in the region. Even when labor is not highly-skilled, the tendency would still be to substitute the other factors of production with it as the cheapest one which affects quality negatively. While good innovative methods of production, that can yield outstanding quality, are generally missing, poorly made products may be what producers actually target. Inferior quality may be the result of pure production considerations.

The substitution of other inputs with labor is very much predetermined by structural economic problems in Eastern Europe. High unemployment, economic stagnation and limited demand for labor make it relatively cheap compared to the other factors of production. Former socialist enterprises undergoing privatization as well as newly-emerging private firms rely more heavily on labor in the production process and less so on capital. Fresh capital in both old and newly-established companies is lacking.[12] The direct impact on quality is that it is generally worse than that of their western counterparts produced with a lot more technology involved in the production process. Quality problems thus arise at the very production level, while few firms are truly dedicated to quality.

A natural force driving product quality down in the region is the type of demand firms are faced with. Depending on the sector or the country, domestic demand can be a driving engine for the overall competitiveness of local producers helping them to respond more adequately to the needs of the global market. Sophisticated and demanding consumers are a necessary condition to boost local production and sustain its competitive advantage. But generally the East European consumer is a low-income, cost-concerned buyer.

Statistics show that domestic demand in Bulgaria has declined dramatically during the transitional period with the decreasing purchasing power of individual and industrial consumers. Bulgarian GDP fell by about 30% with most notable drops in 1990-1991 and 1996-1997 paired with a substantial fall in real wages. In 1999 wages were only around 53% of their 1990 level while the purchasing power of households in the period 1990-1996 declined between 2.3 and 4 times for various commodities.

The downfall came with shifts in the structure of household consumption where the share of food items in total consumption increased from 36% in 1990 to 54.4% in 1997. With the relative stabilization of the economy after 1997 real income has

[12] This is one of the major problems of the worker-manager type of privatization that has taken place in Bulgaria recently. This type of privatization scheme gave preferential rights to workers and managers of former socialist enterprises to buy the latter, the leading motives being to give an advantage to the "creators" of those enterprises and to have Bulgarians own many of the firms rather than to allow foreigners to take over the "national wealth." It was also practiced in cases of little interest to the company on the part of foreign investors. Very soon the deficiencies of this scheme of privatization were realized. Fresh capital, advanced technologies, managerial and expert know-how and secured markets for the output, all being the engines that drive production in a developed industrial economy, were missing in Bulgaria.

somewhat increased and the share of food products has declined to 44.2%. The share of clothes and shoes in total consumption has plunged from 9% in 1993 to 6.5% in 1996 and to 5.5% in 1999. Many goods are not part of the budget set of the average citizen who may spend less than $1 in the form of daily allowance. A large number of people limit their consumption to very basic items, mostly of poor quality, priced relatively low.[13]

Poor buyers cannot be sophisticated, demanding consumers. Low-income levels dictate that mostly inferior products be purchased, normal goods being in low demand. There is a deliberate trend to produce inferior goods solely because consumers and households cannot afford expensive wares. Even when a consumer desires a better than the average product, he has to put up with a mediocre one[14]. The problem of the past seems to be persisting. Premium quality items are not available because producers often believe it does not pay to provide those. In theory optimal quality is one where the marginal benefit to the consumer of an extra effort of improving quality is just equal to the marginal cost to the producer in providing this extra effort. For East European producers it is costly to provide more quality, while the income of people does not allow spending more on superior products. As a result it is mostly inferior commodities that are purchased and rarely normal goods. This is a mechanism through which poverty establishes a level of quality on local markets that hinders the functioning of those markets.

What should be stressed out is that the income effect for East European consumers works in the opposite direction of their substitution effect. In the extreme case of Giffen goods economic theory dictates that the income effect supersedes the substitution effect, thus leading to positively sloped demand. The buying decisions of East Europeans are more strongly affected by income than by quality. Luxury goods assumed to be normal goods quite often are not affordable to the average citizen who more often than not eats cheap, inferior quality pizzas, drinks inferior quality soda and drives an inferior quality car[15].

It is debated in economic literature whether inferior goods and inferior quality goods are the same thing. Hicks (1946, 28) seems to equate the two:

> *"the commodity X is an "inferior" good, largely consumed at low levels of income, but replaced, or partially replaced, by goods of higher quality when income rises. Margarine is obviously a case in point; its inferiority is well attested by statistical investigation. But it can hardly be doubted that there*

[13] Statistical Yearbook of the National Statistical Institute (NSI), Sofia, 1998, 1999, 2000

[14] In extreme cases people end up consuming dangerous products examples of which are numerous – from dangerous electrical appliances to toxic textiles to risky food items to poisonous alcohol that have caused a substantial number of casualties. Several mechanisms have been designed to protect consumers from such risks. Two major legislative acts are the Law for Protecting Competition and the Law for Protecting Consumers and the Rules of Trade. Other laws adopted by the Bulgarian Parliament targeting quality and quality standards are the Law of Measurements, the Law of Technical Requirements for Products, the Law of Wine and Liquor, the Law of Foodstuffs, as well as the Law of Tourism. Organizations such as the Commission for Protecting Competition, the Commission for Protecting Consumers, the Bulgarian Consumer Association, the Quality Center and a number of private organizations have been established with the purpose to safeguard consumers and firms from market risks and to ensure quality. Generally, though, it is considered that state control over production requirements is loose and that firms can easily diverge from government-imposed quality standards.

[15] In the context of Akerlof's example it could be concluded that East Europeans who buy their cars from second-hand markets in Western Europe end up driving only "lemon" cars.

are a great many others. Most of the poorer quality goods offered for sale are probably, in our sense, inferior goods."

Gould (1981, 404) disagrees with this view. He quotes Lipsey and Rosenbluth (1971) and Lancaster (1966) that a good may be inferior even though none of its characteristics are inferior and that inferior and Giffen goods are more common than is generally supposed. His ultimate conclusion is that negative income elasticity need not be associated with inferior quality. Except for inferior quality negative income elasticity could be explained with the fact that there are some opportunity costs of two goods where the consumption of one good may interfere with the enjoyment of the other. The two commodities may compete for the consumer's time while neither one is of inferior quality. Gould calls these "non-cooperant goods." He stresses factors other than quality more strongly but he does not seem to deny that a good of an inferior quality is, indeed, an inferior good. Inferior quality seems to be a sufficient, though not a necessary condition for inferiority.[16]

East European consumers consume goods that owe their inferiority to inferior quality. Most goods have negative income elasticities and the lower the income the greater quantities of them are consumed; the lower the income, the poorer the quality of the goods.

Naturally, there could be other factors affecting quality. Fashion and the sale of trendy items may dictate that quality considerations be combined with product durability where fashionable goods do not have to be very long lasting because of quickly changing tastes and preferences. The change in tastes generally causes instability in demand patterns making it hard for producers to predict what future needs would be. But when producers themselves set the style or create a particular type of demand, it could be that they decide what the quality of the item should be. In more dynamically changing industries such as the apparel and shoe industry, for example, fashion could be the reason for a quality slightly lower than the optimum. As we know, excess capacity is the cost of having variety in a monopolistically competitive industry.

Quality problems thus seem to be inherent in the economic system in post-communist societies. Because nearly all of those countries face considerable poverty, mass products tend to carry less than the optimal quality. Poor quality stems from deep structural problems in the economy, both behavioral and objective. The problem of inferior quality in Eastern Europe should not be seen simply as a conjuncture attribute of the economic process but as a fundamental predicament to economic development that is to endure. The issue of quality is of

[16] One could still argue with Gould that inferior goods owe their nature to their inferior quality. He points out that the capacity of the human palate to benefit from lubricants for bread is limited, and that margarine and butter are non-cooperant goods as increasing one will reduce the marginal utility of the other. Clearly this is so and margarine taken alone may be of primary quality. When quality is evaluated and a single product is viewed separately or within its narrow product group that is the result we obtain. But if quality is defined more broadly and the product is compared with some not so close substitutes the consumer may appear to think it is of inferior quality to those superior products available. Compared to butter, margarine is, indeed, of inferior quality. When the income of the consumer increases and he faces the dilemma of choosing he does not evaluate the good on its own. Rather, he chooses from a larger commodity set. The other example of non-cooperant goods provided, that of books and boats, illustrates this idea better. Both are time-consuming leisure goods. Gould thinks it is unlikely that books be regarded as of inferior quality but to a richer consumer books may be of inferior quality in relation to boats. Confronted with the two alternatives for leisure many individuals would choose sailing to reading.

crucial importance to the region and its economic welfare in the process of transition.

The Effect on Transaction Costs

The manifestations of the quality problem are numerous and conflicts over quality arise all the time between producers and consumers, consumers making consistent claims and producers being reluctant to address those claims in a proper manner[17]. Quality claims accompany the process of trade both on the market for consumer goods where consumers desire much better quality and on the market for industrial goods where commercial partners share much more conflicting than harmonious interests. Barzel (1984, 8) acutely describes the latter situation:

> *"…The seller can get away with some cheating, and given maximization, cheating will occur. Under competition, price will adjust to the cheating. What is costly, however, is not the cheating per se; rather resources are devoted to cheating and its prevention which sharply distinguishes the outcome from that obtained in the Walrasian world."*

Inferior quality in general is not a problem in the process of exchange. It becomes a problem when it is misrepresented and when an inferior product is sold as superior. This is so because there is a loss of welfare and resources attributable to cheating and to disguising quality. Misrepresented quality turns out to be costly in that it takes away wealth from society. The need for inspection and verifying quality, of measuring the exact level of quality agreed on brings to the occurrence of quality *ex post* transaction costs. The costs of locating a partner, offering the needed quality, are search costs that represent an *ex ante* type of transaction costs. Both the search costs and the enforcement costs of providing the necessary quality an economic agent seeks represent a large subgroup of transaction costs and it can be concluded that quality is, essentially, one of the greatest sources of transaction costs in Eastern Europe. Quality transaction costs may be associated with the risk of not finding the desired quality or not receiving it after the conclusion of the contract. As this risk is quite substantial in economic relationships, quality seems to be a major detriment to economic exchange. For a system of exchange in which agents are consistently likely to sacrifice quality in pursuit of their own benefit, quality will be a major detriment to the market and transaction costs of measuring and ensuring quality would be a substantial share of the total transaction costs.

Outside of the context of transaction costs of measuring quality Akerlof (1970, 496) makes a very interesting observation about measurement. He discusses merchants and their important skill to distinguish good quality from bad quality:

> *"In our picture the important skill of the merchant is identifying the quality of merchandise; those who can identify used cars in our example and can guarantee the quality may profit by as much as the difference between type two traders' buying price and type one trader's selling price. These people are the merchants. In production these skills are equally necessary – both to*

[17] In the old days one could not return a shoddy product to its producer or to the store where it was purchased. This was the traditional socialist commerce where consumers could not make claims over defective products. It is still the case in many localities in Bulgaria. Though the new marketing approach is breaking through, one could still sense the lack of enthusiasm in producers and retailers with regard to claims, something they did not have to deal with in the past.

be able to identify the quality of inputs and to certify the quality of outputs. And this is one reason why merchants may logically become the first entrepreneurs."

It turns out merchants have the invaluable skill to determine quality, to tell a "peach" from a "lemon" and to measure quality levels at low cost. This they do better than the average, ignorant person who will find out about quality only after experiencing it. But the fact that there are such people present on the market means they act in the direction of lowering the transaction costs of quality setting and measurement. They know both how to determine optimal quality in production depending on what the market needs and how to inspect it whenever a deal is to be concluded. Quality experts are needed to ease exchange and to make it less costly but are there such people in transitional countries ? A quick look shows that in Eastern Europe such expertise is scarce. As people were not quality conscious in the past, there are hardly many knowledgeable individuals who can tell good quality from bad. Managerial know-how and talent are lacking in the field and this becomes evident when production decisions about optimal quality have to be taken. Akerlof (1970, 496) sees two ways in which quality variations impede development:

"First, the pay-off to trade is great for would-be entrepreneurs, and hence they are diverted from production; second, the amount of entrepreneurial time per unit of output is greater the greater the quality variations."

The transaction costs to variable quality seem to be high in that entrepreneurs have to invest more time in detecting it, something that repeats Barzel's idea of the cost of cheating. These are again quality measurement transaction costs. According to Akerlof quality in the form of "quality variations" impedes development. Nowhere does he explain why there are these "quality variations" in the less developed world causing the collapse of markets or why quality there is much lower than in the West. While he explains meticulously the effect of quality on the market, he does not seem to be concerned with the forces driving lower quality. Furthermore, he does not say why quality is particularly a problem of the East.

It is true, indeed, that contemporary East European managers have to spend a lot of time measuring and verifying quality. This they have to do to ensure that they obtain the right type of inputs and services to use in production. Quality-driven firms are forced to abandon unreliable suppliers, not so dedicated to quality. And we should expect, as Akerlof observes, those quality knowledgeable and conscious people to become the future successful entrepreneurs in East European business.

Providing lower quality and marketing inferior products requires substantial resources, the costs of which exceed what is normally accounted for. Akerlof's conclusion is that legitimate businesses will be driven out of the market. This is more or less a form of disloyal competition practiced in certain markets where quality-driven producers get easily replaced by not so conscientious ones. Akerlof (1970, 495) discusses the costs of dishonesty thus:

"The cost of dishonesty, therefore, lies not only in the amount by which the purchaser is cheated; the cost also must include the loss incurred from driving legitimate business out of existence."

The full economic costs of dishonesty include much more than the effect on the customer. At the very beginning he points out that the paper "presents a struggling attempt to give structure to the statement: “Business in underdeveloped countries is difficult”; in particular structure is given for determining the economic costs of dishonesty” (Akerlof 1970, 488)). And then he reinforces it: “Dishonesty in business is a serious problem in underdeveloped countries” (Akerlof 1970, 495). Therefore, Akerlof seems to think there is a direct correlation between quality problems and economic development and, extending the idea further, it could be concluded that quality hampers economic development and should be a major item on the “research agenda” of scholars studying economic development.

Arrow (1969), quoting Banfield (1958) that “the lack of trust is indeed one of the causes of economic underdevelopment,” seems to agree, too, that economic development and the presence of trust go together. The point that Akerlof is making is crucial to understanding the problems of developing countries, of business and markets in them. It has an important implication for East European economies but it often seems like that aspect of Akerlof’s idea is ignored and the emphasis is mostly on the study of quality in itself. Economists seem to care more about inferior versus superior quality and how inferior quality affects the market in general taking it out of the specific context in which Akerlof uses it. It should be understood that lower than negotiated quality is merely the result of opportunism and is a subjective, rather than an objective hindrance to economic development. This specific reference to underdeveloped countries seems to be particularly important to Akerlof but it has not been emphasized enough by scholars and less so by Eastern European scholars. Clearly, those economies are developing, rather than developed and the relevance of Akerlof’s paper to their problems is, no doubt, significant.

Akerlof goes on to explain dishonesty in the context of underdeveloped countries. He claims that there is considerable evidence that quality variation is greater in underdeveloped than in developed countries and that “quality variation is a greater problem in the East than in the West” (Akerlof 1970, 496). Akerlof gives several examples of poor quality in the conditions of economic underdevelopment. Together with the general example of the insurance business he discusses employment opportunities before minorities in relation to signaling quality, the problems of Indian housewives purchasing poor quality rice and credit markets in less developed countries where local moneylenders have nearly full information about those they give credit to.

In the introduction he discusses some market statistic that consumers often use to judge about the quality of the prospective purchases. This serves as a sort of an incentive for free riding on the side of some sellers about whom Akerlof (1970, 488) says:

> *“In this case there is incentive for sellers to market poor quality merchandise, since the returns for good quality accrue mainly to the entire group whose statistic is affected rather than to the individual seller. As a result there tends to be a decrease in the average quality of goods and also in the size of the market.”*

This is to say that whenever consumers judge about the individual firm’s product quality from the total market quality or that of the entire industry, there is a tendency for some producers to lower quality and “free ride” on the reputation of others. Say, the shoe industry is prospering in Bulgaria and there are quite a few producers of relatively good shoes. Then there is room for some firms to produce sloppy shoes. This they can do because the Bulgarian consumer can never be sure of what he is buying on a market with such diverse producers[18].

It is time to ask why the presence of low quality is an inherent obstacle to economic development. What is the relevance of product quality to transitional economies confronted with the challenges of poverty, unemployment, stagnation and high transaction costs ? It is inevitable to ask this question when the economic well-being of East Europe is at stake and when the transition seems such a painful and fruitless process. It was already stressed out that in their past countries in the region have experienced factors inducing quality problems. On the other hand, poverty and underdevelopment seem to go hand in hand with dishonesty, while dishonesty generates poverty. By making markets futile dishonesty prevents obtaining the gains from exchange and hinders the creation of wealth. By not advancing their markets East European countries fail to achieve specialization, gains from exchange, and, consequently, economic growth.

While the attempt to revitalize the economy and overcome poverty may be to produce more goods in order to satisfy demand, it is mostly goods of inferior quality that are supplied to consumers. This is consistent with the low-income, low profile demand the economy provides for. Producers thus have the tendency to sell more of the inferior goods, removing "superior" products out of the markets. The effect on the market is destructive which, ultimately, causes underdevelopment. Poverty reproduces itself and product quality seems to be a key factor in this process. The vicious circle is closed with the death of the market and the loss of welfare.

Akerlof (1970, 488) calls for government intervention. To him in the market for "lemons" social and private returns differ, the reason being that society, overall, loses whereas certain individuals gain. It could be restated as costs to society exceed greatly the benefits to those few individuals. The true costs are not only the costs of not having something of value or the desired quality level but also the costs of driving a legitimate business out, the costs of losing an entire market. It is also apparent that quality effects cannot be captured by prices and in the general case quality represents a brilliant illustration of a market imperfection. As an alternative solution Akerlof (1970, 488) suggests the formation of private institutions that "may arise to take advantage of the potential increases in welfare which can accrue to all parties." Whenever the problem of inferior quality arises some governmental or private observance may be necessary according to Akerlof.

Reputation as Seen by the East European Producer

The idea behind the dynamic model of reputation is that the firm would maximize its value by being loyal long-term, rather than increasing short-term profits from selling low-quality products (Shapiro 1983). According to Klein and Leffler (1981, 152) prices, sufficiently above salvageable production costs, are the necessary and sufficient condition for performance, "so that the non-performing firm loses a discounted stream of rents in future sales which is greater than the wealth increase from non-performance."

The model is dynamic in that firms choose prices and quality levels in every period where consumers have an expectation about the quality that is equivalent to the firm's reputation. Consumers can only determine the actual quality after the

[18] Which is, indeed, the case with Bulgaria.

purchase and asymmetric information is already present. The firm has to choose whether to maintain the high quality anticipated by consumers or to increase its profits in the short run by undercutting quality which will result in losing those customers afterwards. The firm would invest in quality and reputation only to the point where it pays more than cheating on consumers. As Telser (1980, 29) puts it "someone is honest only if honesty, or the appearance of honesty, pays more than dishonesty."

Let κ be again the quality of the product and let the unit cost $c(\kappa)$ vary with it. The product price $p(\kappa)$ also depends on the level of quality:

$$\frac{\partial p}{\partial \kappa} > 0 \qquad \frac{\partial c}{\partial \kappa} > 0$$

For East European producers it must be that:

$$p(\kappa) - c(\kappa_0) \geq \left[p(\kappa) - c(\kappa)\right]\frac{(1+i)}{i}$$

where κ_0 denotes some lowest level of quality that could be provided to consumers. The interest rate at which a perpetual flow of revenues from reputation is discounted is i. East European firms, which cheat on quality, obtain greater one-time benefits represented by the left side of the inequality. Their revenues attributable to reputation are far smaller than those from cheating.

Rearranging the inequality yields:

$$p(\kappa) - c(\kappa) \leq i\left[c(\kappa) - c(\kappa_0)\right] \qquad (3)$$

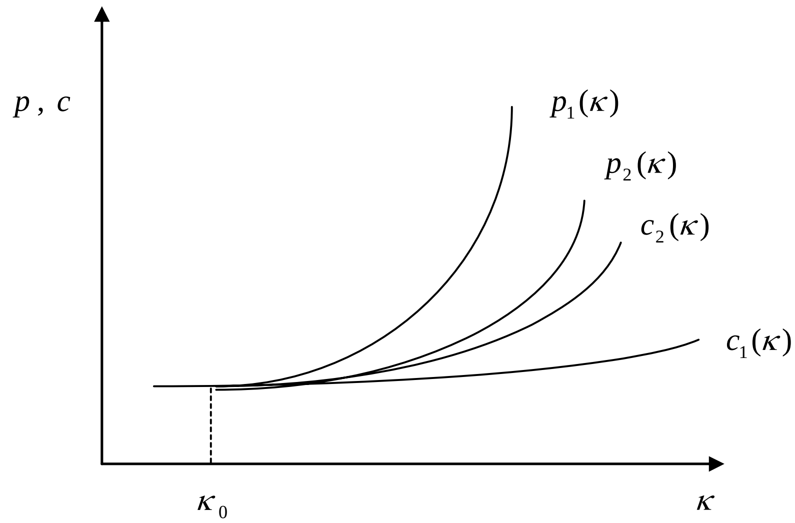
which implies that the per unit profit of selling only high quality merchandise is less than the rent accruing to maintaining reputation represented by the right-hand side. The profit should exceed this rent in order for the firm to be enticed to invest in reputation by sustaining quality. At the equilibrium the difference between the price and the unit cost is just equal to the rent as the return on quality.

$$p(\kappa) - c(\kappa) = i\left[c(\kappa) - c(\kappa_0)\right]$$

However, the costs of producing at a given level of quality $c_2(\kappa)$ for East European producers exceed those of western firms $c_1(\kappa)$ as it is more costly for East European companies to provide that quality with the available inputs. At the same time the price they can charge $p_2(\kappa)$ is generally lower than what western firms charge or $p_1(\kappa)$. This may be related to the fact that western consumers are sophisticated and more affluent and value good quality more than easterners. Eastern European consumers severely constrained by their budgets are less quality driven and more income driven in their buying decisions. Thus, for western consumers price is a more rapidly rising function of quality.

Figure 1 shows that the profit of sustaining high quality may be very small for the East European producer. It is likely to be less than the rent from reputation and he has little incentive to sustain quality. The profit to the western producer substantially supersedes that of his Eastern European counterpart as $p_1(\kappa) - c_1(\kappa) > p_2(\kappa) - c_2(\kappa)$. Reputation thus is far more important for firms in the West than for East European firms and quality in the West is higher than that in the East.

Figure 1



In the worst case it may be that price does not cover the unit costs incurred by the East European producer since consumers can afford to pay for quality less than it costs to produce. Then the profit obtainable from quality becomes negative. As the rent is always positive since $c(\kappa)-c(\kappa_0)>0$, it follows that inequality (3) will hold true. The producer then is sure to cheat. Since costs of quality usually exceed revenues in Eastern Europe most products sold as superior products are lemons.

Figure 2

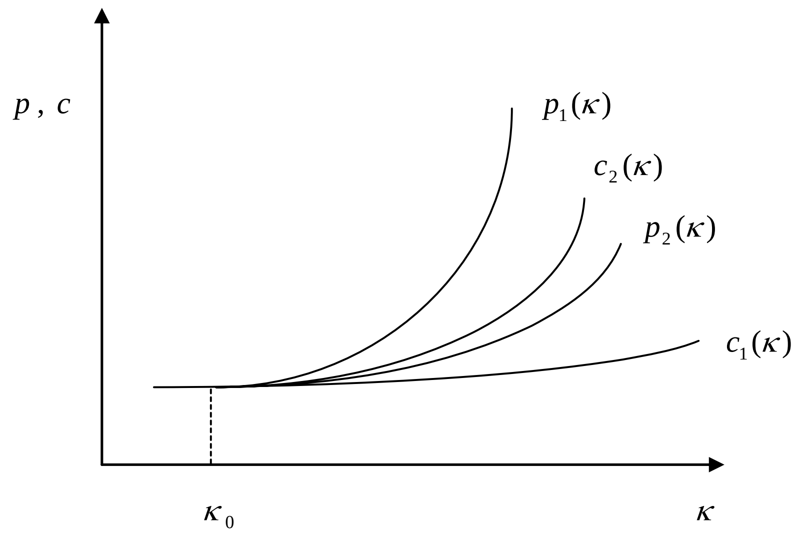


Figure 2 illustrates that keeping up quality may in fact be bad for East European producers as the costs of quality exceed the revenues from it. Firms would gain greater profits by being dishonest and deceiving consumers than by being loyal long-term. Firms that are disloyal benefit while honest firms do not gain much or lose. Dishonesty pays more than honesty in Eastern Europe.[19]

Quality Commitment, Technology and Trust

It is hard to prescribe ways out of any vicious circle, which in the case of poverty and economic regress looks like a deep and inescapable whirlpool. This represents a major challenge before transitional economies and one way to deal with the problem invariably is quality commitment. What the optimal level of quality should be depends on each and every transaction and marginal analysis provides the ground for setting the right quality.

The commonly low level of quality in post-communist economies necessitates that changes be made to foster local markets. An appropriate culture should be nurtured in both producers and consumers that would help bring down the costs of production while increasing the quality conscience of the average citizen. Quality should be the aim of all businesses. Instead of having to deal with constant claims over bad products and services producers would be better off insuring and signaling quality.

Advertising is clearly one such signal, which provides a separating equilibrium between low and high quality (Nelson 1974). It is less costly for high-quality producers to signal quality by means of advertising than it is for low-quality producers. Advertising may serve as a proof that the producer is truly dedicated to quality. But advertising on its own is not sufficient – it should be accompanied by considerable improvements in product features and functions. Investments in “brand-name capital” can serve as an indication of the quality level of the product and can “act in a sense as “hostages” in the hands of the firm’s customers” (Furubotn and Richter 2000, 226).

A primary signal of quality commitment can be the provision of warranties where the size of the warranty payable to the customer is negatively correlated with the level of quality. Thus, investments in quality control techniques (TQM) and continuous quality improvement may result in lower costs of warranties. A warranty can certainly communicate to customers that the firm is, indeed, committed to quality and is building on its long-term reputation.

Other means to signal quality include product samples, exhibitions, trial periods, etc. In the context of the labor market and employer-employee relations university degrees, scholarly achievements, good credentials, substantial work experience and references from previous employers may be first-degree indications of job performance and efficiency. All of these insure quality and help avoid moral hazard and opportunism at the work place.

A major determinant is the level of technology adopted by firms and it is apparent that technologically lagging economies cannot provide superior quality products. By

[19] Roma sellers and street salesmen in the region apply the most “successful” marketing techniques in deceiving the customer. Their strategy is effective because consumers have no way of tracking those vendors down when they discover the inferior quality of the merchandise. By moving from one place to another they ensure that buyers cannot punish them in any way. Street trade is proliferating in the region with “sidewalk vendors” selling everything – from cheap socks to “gold” chains to aspirin.

investing in new, modern technologies East European countries can hope to produce much better products at low cost that can successfully compete globally. But it is critical to understand that quality is not only a problem of global competitiveness, it is a fundamental problem to the advancement of domestic markets. Therefore, quality has to be a priority for local firms that should completely abandon the production of inferior quality merchandise or what the market can bear.

One last direction to take is to invest in trust and trust relationships at the marketplace. For trust is crucial for the smooth functioning of markets. Akerlof (1970, 500) says:

> *"We have been discussing economic models in which "trust" is important. Informal unwritten guarantees are preconditions for trade and production. Where these guarantees are indefinite, business will suffer... But the difficulty of distinguishing good quality from bad is inherent in the business world; this may indeed explain many economic institutions and may in fact be one of the more important aspects of uncertainty."*

Quality should be perceived as the subject of a self-enforcing agreement whereby each contracting party commits itself to it and "the only recourse of the party who discovers a violation of the contract terms by the other side is to terminate the agreement" (Furubotn and Richter 2000, 156). When one party cheats the other party may retaliate. But quality is mostly the result of self-enforcement in that the party, based on its moral values, tradition and loyalty, commits itself to providing the negotiated quality.

Economic agents must be educated about the importance of being ethical and prompt in business deals. Building such habits without any foundation is a burdensome task. It can be achieved by having an active state set clear rules of the market game whereby not everyone will be allowed to participate but only the economically efficient and honest agents. The process will be long, painful and costly because the market is an expensive mechanism that takes time, education and resources to build.

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