Brand Names

By Benjamin Klein

Consumers pay a higher price for brand-name products than for products that do not carry an established brand name. Because this involves paying extra for what some consider an identical product that merely has been advertised and promoted, brand names may appear to be economically wasteful. This argument was behind the decision to eliminate all brand names on goods produced in the Soviet Union immediately after the 1917 Communist revolution. The problems this experiment caused—problems described by economist Marshall Goldman—suggest that brand names serve an important economic function.

When the producers of products are not identified with brand names, a crucial element of the market mechanism cannot operate because consumers cannot use their past experience to know which products to buy and which not to buy. In particular, consumers can neither punish companies that SUPPLY low-quality products by stopping their purchases nor reward companies that supply high-quality products by increasing their purchases. Thus, when all brand names, including factory production marks, were eliminated in the Soviet Union, unidentified producers manufacturing indistinguishable products each had an incentive to supply lower-quality goods. And the inability to punish these producers created significant problems for consumers.

Consumer reliance on brand names gives companies the incentive to supply high-quality products because they can take advantage of superior past performance to charge higher prices. Benjamin Klein and Keith Leffler (1981) showed that this price premium paid for brand-name products facilitates market exchange. A company that creates an established brand for which it can charge higher prices knows that if it supplies poor products and its future DEMAND declines, it will lose the stream of income from the future price premium it would otherwise have earned on its sales. This decrease in future income amounts to a depreciation in the market value of the company's brand-name. A company's brand-name capital, therefore, is a form of collateral that ensures company performance. Companies without valuable brand names that are not earning price premiums on their products, on the other hand, have less to lose when they supply low-quality products and their demand falls. Therefore, while consumers may receive a direct benefit for the extra price they pay

for brand-name products, such as the status of driving a BMW, the higher price also creates market incentives for companies with valuable brand names to maintain and improve product quality because they have something to lose if they perform poorly.

Brand-name quality assurance is especially important when consumers lack complete INFORMATION about product quality at the time of purchase. Companies may take advantage of this lack of information by shaving product quality, thereby lowering costs and increasing short-term PROFITS. A company that takes such actions, however, will experience a decrease in its future demand, and therefore in its long-term profits. The greater the value of a company's brand name—that is, the greater the PRESENT VALUE of the extra profit a company earns on its sales—the more likely it is that this long-term negative effect on profits will outweigh any short-term positive effect and deter a policy of intentional quality deterioration. Moreover, the greater the value of a company's brand name, the more likely the company is to take quality-control precautions. To protect its brand name, a company will want to make sure its consumers are satisfied.

When it is difficult to determine the quality of a product before purchase and the consequences of poor quality are significant, it makes economic sense for consumers to rely on brand names and the company reputations associated with them. By paying more for a brand-name product in those circumstances, consumers are not acting irrationally. Consumers know that companies with established reputations for consistent high quality have more to lose if they do not perform well—namely, the loss of the ability to continue to charge higher prices. A company's high reputation indicates not only that the company has performed well in the past, but also that it will perform well in the future because it has an economic incentive to maintain and improve the quality of its products. A consumer who pays a high price for a brand-name product is paying for the assurance of increased quality.

When a company performs poorly, the brand-name, market-enforced sanction it faces is usually much greater than any court-enforced legal sanction it might face. Consider, for example, the case of defective Firestone tires on Ford Explorer sport-utility vehicles in 2000. Because consumers cannot ascertain the quality of tires by direct examination, they rely largely on the tire supplier's brand name, which was badly damaged in this case. One day after Bridgestone (Firestone's Japan-based parent company) announced the recall of the defective tires, Bridgestone's stock price dropped nearly 20 percent; it continued to fall over the next three weeks as additional information about the problem was disclosed. Overall, this amounted to a decline of nearly 40 percent in Bridgestone's stock-market value relative to the Nikkei general market index. Ford's stock price did not drop initially, but eventually it fell about 18 percent relative to the S&P 500 index over the same period as information was revealed that Ford was aware of the possibility of tire failure more than a year before the tire recall. These stock-market declines amounted to losses of about $7 billion in Bridgestone's market value and nearly $10 billion in Ford Motor Company's

market value—market measures of each company's future lost profit caused by these events. These costs were substantially greater than the direct costs associated with the recall and LIABILITY litigation, estimated by Bridgestone at $754 million and by Ford at $590 million. Although these direct costs clearly were substantial, they were dwarfed by the brand-name market costs borne by Bridgestone and Ford, which were between some nine and seventeen times as large.

Similar market effects occurred in 1993 when *E. coli* bacteria in the hamburger meat purchased by Jack-in-the-Box killed four people and sickened about five hundred. Although Jack-in-the-Box reacted quickly to the food poisoning and took actions to prevent its recurrence, its stock-market value fell by more than 30 percent when this information was disclosed, or more than double the direct litigation and recall costs. Even in cases where the problem is not strictly the company's "fault," such as the 1982 Tylenol tampering cases that led to seven poisoning deaths, the $2 billion (or more than 20 percent) decline in stock-market value borne by the producer, Johnson and Johnson, was almost ten times as great as the company's direct recall and litigation costs. While the government regulates the quality of products, the regulatory cost that can be imposed on companies is generally a small fraction of the economic cost that the market imposes on poorperforming companies with established brand names. If those companies had lacked brand names, the economic punishment they suffered would have been much smaller.

Because brand-name companies have a greater incentive to ensure high quality, consumers who buy brand-name products are necessarily paying for something: the added assurance that the company has taken the necessary measures to protect its reputation for quality. Therefore, even for purchases of a "standardized" product such as aspirin, where most suppliers purchase the basic ingredient, acetylsalicylic acid, from the same manufacturer, it may make sense for consumers to purchase a higher-priced brand-name product. Consumers are not ignorant or irrational when they buy an advertised brand-name aspirin rather than a non-brand-name product at a lower price. Bottled aspirin supplied by brand-name and "non-brand-name" producers may differ technologically in dissolve rate, shelf life, and other factors. But more important, the products differ economically. A lower-priced "nonbrand" aspirin is not economically equivalent to higher-priced brand-name aspirin, because a company selling aspirin under a valuable brand name has more to lose if something goes wrong. The brand-name aspirin supplier, therefore, has a greater economic incentive to take added precautions in producing the product. Similar economic forces are at work when multiple generic drug companies produce the same drug. Because pharmacies generally have an incentive to purchase the lowest-cost generic variant, each generic company has the incentive to lower costs, including reducing its quality-control efforts, subject only to imperfect FDA audits. When companies do not earn a large price premium on their products, the potential sanction the companies face for poor quality control is much lower than the economic cost borne by brand-name companies.

Seen in this light, the question is not whether consumers are ignorant or irrational when they pay a higher price for a brand-name product, but whether they are paying too much for the additional quality assurance brand names necessarily provide. Even people who assume that all aspirin is alike spend *some* money on brand-name assurance since they do not buy "nonbrand" aspirin off the back of a pickup truck at a swap meet. Instead, they may buy "lower-brand-name" aspirin, such as aspirin carrying the brand name of a chain drugstore. It is significant, however, that consumers buy a much smaller share of such "lower-brand-name" aspirin when purchasing children's aspirin than when buying adult-dosage aspirin. Many people decide, as evidenced by their behavior, that although they are willing to purchase less brand-name assurance for themselves, they want the higher-quality assurance for their children, for whom quality-control considerations may be more important.

About the Author

Benjamin Klein is professor emeritus of economics at UCLA and director, LECG, LLC.

Further Reading

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Mitchell, Mark. "The Impact of External Parties on Brand-Name Capital: The 1982 Tylenol Poisonings and Subsequent Cases." *Economic Inquiry* 27, no. 4 (1989): 601–618.