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Location costs, product quality and implicit franchise contracts

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Abstract

In the literature on international trade, only little attention has been given to informational asymmetries between firms and consumers with respect to product quality. The few economic models that analyze the question of how asymmetric information about product quality might affect trade flows treat product quality as exogeneous. In contrast, our model takes product quality as an endogeneous variable, i.e. firms can choose the quality they wish to produce. In this case, location costs can signal product quality under certain conditions and thereby affect international trade flows. More specifically, intra-industry trade in vertically differentiated experience goods can be determined by information asymmetries about product quality. © 2000 Elsevier Science B.V. All rights reserved.

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1. Introduction

The literature on strategic trade policy, initiated by Brander and Spencer (1985) and reviewed by Brander (1995), analyzes the effects of trade policy under

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conditions of imperfect competition. These models demonstrate that government intervention may be beneficial for a country in some situations. What is rather surprising in this context is that potential effects of asymmetric information have only been explored to a rather limited extent – although we have known at least since the path breaking work of Stigler (1961) and Akerlof (1970) that markets with even small informational asymmetries are qualitatively different from markets with symmetric information. The few models that deal with trade policy under asymmetric information almost exclusively focus on informational asymmetries either between firms and the government (Brainard and Martimort, 1997) or between domestic firms and foreign rivals (Collie and Hviid, 1993). Common to these models is the idea that government intervention may be beneficial for a country by making an output expansion of the home firm credible. Moreover, as Qiu (1994) has demonstrated, if neither the domestic government nor a foreign rival can observe the firm's costs, the government can play a second role: by offering a separation inducing menu firms might eventually be enabled to signal their costs to a foreign rival.

Only little attention has been given to informational asymmetries between firms and consumers and the question of how these asymmetries may affect international trade. Particular exceptions are the models of Mayer (1984), Grossman and Horn (1988) and Bagwell and Staiger (1989) which discuss a country's optimal trade policy when (foreign) consumers are uninformed about domestic product quality. As these models do, we will consider the case of an ''experience good'' for which the quality is unknown to consumers.[1] However, our model differs in important respects. First, the models mentioned above assume that product quality is either exogeneously determined or given by the firm's technology which the firm chooses once and for all before it enters the market. In either case, any credibility problem is resolved once consumers have learned a firm's product quality. In contrast, we will treat quality as a choice variable in any single period, so that there is a moral hazard or commitment problem connected with product quality.[2] Accordingly, the mechanisms by which firms can acquire reputations are quite different. Second, Mayer (1984) assumes that the home country's government is informed about a product's quality. In contrast, we will consider the case in which even the government is uninformed about the firm's type. The government is assumed not to know more than any consumer. Similar to Bagwell and Staiger (1989) and Qiu (1994) we will assume that neither the domestic government nor consumers know a firm's production costs, although they know the distribution

[1]The term ''experience good'' was coined by Nelson (1970). According to his definition a product is considered an experience good if its quality is not evident on inspection and costly to determine before purchase. In contrast, goods for which the quality can be easily determined on inspection have been labelled ''search goods'' (see Nelson, 1970).

[2]In a footnote, Grossman and Horn (1988) briefly mention the possibility of allowing period-by-period quality choice, but do not examine its implications.