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Minimum Quality Standards and Compulsory Labeling when Environmental Quality is not Observable

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This paper studies the effect of a minimum quality standard, a compulsory labeling scheme, and the combination of both instruments in a vertical differentiation model when not all quality dimensions can be observed by consumers. Both a minimum quality standard for the non-observable quality dimension and a labeling scheme that informs consumers about the non-observable quality dimension increase prices and have no effect on the observable quality dimension or market shares. The combination of a minimum quality standard and a labeling scheme increases both the unobservable and the observable quality dimension, increases prices, and shifts market shares from the high quality firm to the low quality firm. Social welfare is higher under the combination of both instruments than under no regulation, the minimum quality standard or labeling applied as only instrument.

JEL Classification: Q58, L13, L15

Keywords: Labeling, minimum quality standard, environmental quality

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