CHAPTER I

ECONOMIC THEORY OF CONSUMER PROTECTION


A. Introduction

1. Why Consumer Protection

The development of modern technology with large-scale enterprises is creating new types of consumer problems in the market place. Ironmonger (1972), "...by the fact that the emergence of new commodities and changes in the character of commodities have become important for consumer commodities only in recent decades. Prior to this, innovation and technological change were largely confined to the means of production rather than the means of consumption. Inventors and innovators were concerned with making existing commodities more efficiently rather than with making more efficient commodities". The consumers are unable to determine the characteristics of goods or services for example, it is difficult to know whether the prescription drug one takes really is effective. Consumers are unable to determine the quality of the services of doctors, lawyers, carpenters etc. Consequently there is a problem of asymmetric information between producers and consumers about the quality of the product.

In the case of production of hazardous products the state should interfere in order to reduce the severity of the damage because some times the consumer has to bear the costs of damage, especially in cases where the producer’s assets are less than the liabilities. In some special cases it is profitable for manufacturers to harm the consumers. For example, Alpha Corporation produces an electric saw that has desirable characteristics but occasionally severs the hand of

the consumer using it. Let us assume that Alpha possesses the technology to make this product perfectly safe at some cost but incur the expenditure to save costs, such a situation calls for state intervention in order to produce safer electric saw. And also consumers some times misperceive the product risks. For example, even when given a correct perception of the risks of cigarette smoking, they would still choose to smoke believing that they are more immune to damaging effects than is objectively the case\(^2\). Thus, misperception merits the state intervention. Therefore, the prevalence of the asymmetric information and the consumer's misperception on product hazards in the market place favours consumer protection.

In addition, in a modern world, most of the products are in mass production. In spite of the advantages of the economies of scale, the mass production process magnifies the problems occurring in the case of defective products. In general there are three types of defects at the time of production of the goods: they are manufacturing defects, design defects, and warning defects. In the case of product defects, some of the products may escape from the standard controls during the production process and reach the market. In the case of design defects, all products are defective and reach the market. The producer of such products should recall the entire products and re-process the production. Design defect seems to be more complicated and costly compared to product defects because in the case of product defects the producer has to call back only the goods which are in defect but in the case of design defects he has to call back entire products. And in the case of warning failure, the manufacturer does not warn the consumer about the dangers involved the usage. At the same time, the production of the product is not the end of the producers' responsibilities, he has to observe the performance of his product in day- to- day use by the consumers, which is known as post- marketing surveillance. Whenever the producers are not practising their duties at the production stage, the state has to do something to force the producers in order to meet their responsibility to reduce product damages to the consumers.

The state has to do something regarding consumer protection, whenever marginal consumers are unable to influence the producer to provide quality products because producers discrimination between marginal and infra-marginal consumers. The producer can provide

\(^2\) Right now in the United States of America, there is a big debate on whether cigarettes should be under the category of drugs or not?
better terms and quality goods to marginal consumers and rip-off the infra-marginal consumers by providing low quality goods at higher prices.

The producers of adulterated products and deceptive advertisers may provide goods at lower prices to the consumers. The innocent, ignorant and illiterate consumer will purchase such goods and ultimately face the risks involved because they are unable to distinguish the product qualities based on the prices. The state has to interfere and curb these types of unscrupulous practices in order to improve consumer welfare. In principle, the state has two instruments i.e. liability and regulatory systems in order to protect the consumer interests. Here, the justification of economic analysis of the alternative legal systems will be reviewed extensively.

II. Traditional Neo-classical Economic Theory, the Role and Influence of the Consumer and the Implications for the Legal System

Economic theory assumes that the consumer is rational in the sense that he tries to maximise satisfaction from a given income. According to Adam Smith, “consumption is the sole end and purpose of all production” which emphasises the importance of the role of the consumer. The classical economists envisaged an economic system of social efficiency in which all incentives encouraged, according to what people wanted most with great efficiency. One of the basic concepts in economics is the consumer sovereignty, “as shown by that the ways in which they spend their money, determine what merchandise is produced and which services supplied”.

The focus will be both on the old theories of consumer protection such as exploitation theory and the new theories of consumer protection such as asymmetric information.

1. Consumer Sovereignty

The notion of the consumer sovereignty is the very heart of the market economy. The term Consumers Sovereignty was coined by Prof. W. H. Hutt, in 1931. Market literature has phrases like “the consumer is always right” and a proverbial expression in high Dutch is “De

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2Quoted in Fullop Christina, Consumers in the Markets, The Institute of Economic Affairs, 1967, p.11.
Klant is Koning” (the customer is king). According to Hutt, “as a concept consumer sovereignty simply refers to the controlling power exercised by free individuals, in choosing between ends, over the custodians of the community’s resources, when the resources by which these ends can be served are scarce”.

“In the good economic society, the consumer is cast in the role of a judge or arbitrator, though not necessarily one possessing absolute or infinite wisdom. As judge, the consumer assigns by his spending pattern the rewards or penalties for specific productive efforts”. For example, when consumers want a good or service, they are willing to pay relatively more for it than when their wants are not as strong. Highly desirable goods and services become more profitable to produce, and resources will flow into their production. Therefore, consumer sovereignty directs the flow of resources into the goods or services that consumers want the most.

The full achievement of consumer’s sovereignty has been known as “Ideal Output”. And also it is very closely related to the idea of economic efficiency, i.e. efficiency in the use of resources for the greatest possible satisfaction of the needs and desires of consumers. In a perfect market economy, “the entrepreneurs and the resource owners must adapt themselves to the verdicts of the consumer. As a producer he is subject and as a consumer he is sovereign”.

2. Perfect Markets

Competitive market is the consumer’s best friend. According to Peter Joy, “the consumers’ only true protection is and should be through the extension and strength of markets”. The orthodox neo-classical economists show that the market system will produce an efficient or

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7Ibid.

Pareto-Optimal outcome. They assume either explicitly or implicitly that the consumers are fully informed not only about the quality and the safety of the goods or services but also that they were fully aware of the terms and the conditions of the warranty contracts and standard form of contracts. Perfect market assumes that the existence of large number of buyers and sellers, a homogeneous product, and a large amount of information, with the result that no individual producer or consumer would have sufficient economic power to control prices. Perfect market system enables the economic problem to be solved in a way which combines efficiency and freedom. Efficiency because individual preferences determine what is produced, and freedom because individuals are free to choose what goods they want. In perfect markets, the consumers can take decisions according to their needs by balancing the costs and benefits of the product risks, so that the consumers will be protected by the first-best solution.

3. Legal Consequences: Freedom of Contract and Non-Intervention

Production and consumption of goods or services are for the purpose of promoting consumer welfare, with no explanation of consumers by producers and vice versa. “In a free market economy, with the interplay of competition, the consumer has freedom to choose either by accepting or rejecting the price charged by the seller and also the selling is dependent upon assured good quality and full measure at prices equal to the cost of production.” Adam Smith contented himself with distinguishing competition from monopoly by its consequence “the price of monopoly is upon every occasion, the highest which can be got.... the price of free competition on the contrary is the lowest which can be taken not upon every occasion indeed but for any considerable time together”.

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9No one can be made better off without some one else being worse-off nor can the output or any good be increased without reducing that of another nor can the quality of any input be increased without reducing the quality of another under Pareto-Optimality.

10Like What shall be produced? How will it be produced? And who will get the product?

11In a perfect market conditions consumers are free to choose, there is no police man to take the money out of consumers pocket to pay for some thing they do not want or to make they do something consumer do not want to do.

Competition is a big stick that enforces order and fair play. It is a self-policing world. The buyer and seller would possess equal bargaining power over transactions. Therefore, the government as well as the system of civil law or common law should also not be necessary to interfere into the freedom of contract. Thus, a contract written or oral should be kept at faith value by the legal order. It is a world of desirable laissez-faire\textsuperscript{11} ruled by Adam Smith's invisible hand, which strongly favours the price mechanism with a little state intervention in order to fulfil the consumer satisfaction by encouraging the competition among the producers.

**B. Traditional Theories of Consumer Protection**

The neo-classical economists assume that in a perfect market, price is equal to marginal cost; that both the producers and the consumers were price takers and also that they are the best judges of their own welfare; prevalence of zero transaction costs; and, the allocation of resources are either perfect certainty or risk neutral. However, it was challenged both by the economics profession and the legal profession starting in the 1930s and the critique of the neo-classical tradition was the exploitation theory (F. Kessler).

**I. Exploitation Theory**

Modern capitalism is completely different from the traditional capitalism. In modern capitalism, there are large firms, industries and large corporations. Market failure, the problem of monopoly is not directly related with the problem of consumer protection. But at the same time it is one of the major institutions in modern capitalism, which has power to control the whole market either by possessing large share of the natural resources or by way of investing huge amounts in research and development. In fact, they can do whatever they want, for example, they can create the scarcity, raise the prices, create the unwanted desires among the consumers through advertisements and they can impose any type of terms or conditions in warranty and standard form of contracts. According to this theory modern capitalism is not competitive capitalism but monopoly capitalism, so that the producers can impose whatever they want on

\textsuperscript{11}Indeed, the expression of laissez-faire, which was intended as an admonition against deliberate restrictions on production and trade, has given rise to the idea that a working market mechanism will automatically arise and with particularly no governmental intervention. For details see Adam Smith
the consumers. Therefore, it is the producer sovereignty and not the consumer sovereignty. From 1930s to 1960s in Germany and in the United States of America, the exploitation theory has played major role regarding drastic changes in consumer laws and legislation.

The expansion of market economy facilitates the members of the community to have an infinite number of typical transactions. In such a situation, the legal system has a role to play to regulate the transactional consequences. But it cannot anticipate the continuously in each and every transaction into which the members of the community may need to enter. Ultimately, society has to give the parties freedom of contract.

"Freedom of contract means that the state has no monopoly in the creation of law. The consent of contracting parties also creates law. The law making process is decentralised. As a result, law is not an order imposed by the state from above upon its citizens; it is rather an order created from below. This is a realistic insight"\(^{14}\).

"Since a contract is the result of the free bargaining of parties who are brought together by the play of the market and who meet each other on a footing of social and economic equity, there is no danger that freedom of contract will be a threat to the social order as a whole"\(^{15}\). But with the establishment of big industries and with the declining of the free enterprise system due to the innate trend of competitive capitalism towards monopoly, the meaning of contract has been radically changed up to standard form of contract. These type of contracts have "become an important means of excluding or controlling the `irrational factor` in litigation"\(^{16}\), for example, the use of warranty clauses in manufacturing industry limiting the common-law remedies of the consumer to breach of an implied warranty of quality and particularly excluding his right to claim damages i.e. exclude warranty recovery from consequential damages. Therefore, "standard form of contracts is the ones typically used by enterprises with strong bargaining power. The weaker party, indeed of the goods or services, is frequently not in a


\(^{16}\)Ibid., p. 632
position to shop around for better terms, either because of the author of the standard contract has monopoly (natural or artificial) or because all competitors use the same clauses.\textsuperscript{17}

In general, consumers do not have any advantages from standard form of contract except some price reductions. These types of contracts in particular could thus become effective instruments in the hands of powerful industrialists and commercial overlords enabling them to impose a new feudal order of their own making upon a vast host of vassals. To be specific, a world in which "producers have secured power" that they use "to rob the rest"\textsuperscript{18}. The most convincing evidence to support the exploitation theory, however, arose from case histories of warranty practices. Courts were asked repeatedly to give effect to warranty provisions that they interpreted as exploitative. In the case of \textit{Henningsen v. Bloomfield Motors, Inc.},\textsuperscript{19} involving serious personal injury from an allegedly defective automobile, the terms of the warranty at issue disclaimed the implied warranty of merchantability, excluding consequential damages, and limited warranty remedies to repair or replacement of the defective part as long as the victim has prepared transport charges for the part. The New Jersey Supreme Court remarked "It is difficult to imagine ... a less satisfactory remedy .... An instinctively felt sense of justice cries out against such a sharp bargain"\textsuperscript{20}. The court embraced the exploitation theory and refused to enforce the terms of the standard warranty\textsuperscript{21}. Thus, the exploitation theory stresses the need of not only a comprehensive quality and safety regulation but also an abridgement of the concept of freedom of contract in favour of a comprehensive system of binding civil law rules of liability in favour of the consumer.

\textsuperscript{17}Ibid.

\textsuperscript{18}See Benn, Producer v. Consumer 25 (1928). The feeling of exploitation on the part of the consumer is sometimes justified by the seller’s stated intentions. Walton Hamilton (1935, p. 1931) Quotes the head of a large department store as saying, "God created the masses of mankind to be exploited. I exploit them; I do his will".

\textsuperscript{19}32 N.J. 358, 161 A. 2d 69 (1960).

\textsuperscript{20}Id. at 375, 388, 161 A. 2d at 79, 85.

II. Producers' Sovereignty

Adam Smith observed that, on the one hand, "consumption as the sole end and purpose of all production", on the other hand, "the interest of the consumer is almost constantly sacrificed to that of the producer, and (the economic system) ... seems to consider production and not consumption, as the ultimate end and object of all industry and commerce"\(^{22}\).

The market imperfections seem to put the consumer in a disadvantageous position in relation to the producer. J. K. Galbraith argues that the concept of consumers' sovereignty must be replaced by the notion of producers' sovereignty. "The Galbraithian position denies that competitive profit maximisation even is a rough approximation to economic reality. Protected by its oligopolistic position from the need to maximising profits, and largely outside the control of capitalists, a "technostructure" internal to the modern corporation organises its activities on the basis of criteria of scarcity, autonomy, market power, technical achievement, and public prestige. Since the technostructure need respond only incompletely to the structure of commodity demanded when it conflicts with these objectives, consumers' sovereignty theory fails to hold"\(^{23}\).

"Consumers are rather vague about what they want. Therefore, someone has to step in to give them right direction. The real initiative lies with producers, who develop new products, decide which of these to put on the market and then persuade consumers to buy them through high-pressure advertising. It is this changed position which has been described by Prof. Galbraith as the principle of revised sequence"\(^{24}\). Instead the consumer telling the producer what should be produced, the position is reversed and it is the producer who tells the consumer what he wants or should want.

\(^{22}\)Smith, n. 3.


Imperfections in the market economy supporting the argument of state intervention to frame the consumer laws and regulations in order to protect the consumers. The unconscionability theory gives a brief idea of how these laws and regulations are really entering into the protection of the consumer.

III. Unconscionability Theory

The concept of unconscionability was first made explicit by the Uniform Commercial Code in order to reconcile it with the bargaining principle. The terms of private agreements could not be set aside because the courts found them to be harsh, unconscionable, or unjust. Arthur Leff (1967) has drawn a distinction between 'Procedural' and 'substantive' unconscionability. These two are often combined in actual cases because an unfair procedure frequently results in an unfair price.

A transaction is unconscionable because gross disparity between the price of the property or services... (and their value) measured by the price at which similar property or services are readily obtainable in the credit transactions by consumers. The norm of unconscionability is closely related to the manner in which the relevant market deviates from a perfectly competitive market. Prof. Eissenberg has proposed four arguments for unconscionability theory. They are:

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25 The bargaining principle- in the absence of a traditional defence relating to the quality of consent (duress, incapacity, misrepresentation, or mutual mistake), the courts will enforce a bargaining according to its terms, with the object of putting a bargain- promisee in as good a position as if the bargain had been performed.

26 It is a fault or unfairness in the bargaining process.

27 It is a fault or unfairness in the bargaining outcome.


29 Uniform Commercial Code, Section 5, 108 (4) (c) 1974.

1 Distress

It is for example, X makes a bargain with Y at a time when, though fault of Y, X is in a state of necessity that effectively compels him to enter into a bargain on any terms he can get. Let us consider the following hypothetical case:

"T, a symphony musician, has been driving through the desert on a recreational trip. When he suddenly hits a rock jutting out from the sand. T’s vehicle is disabled and his ankle is fractured. He has no radio and little water, and will die if he is not secured. The next day, G, a university geologist who is returning to Tucson from an inspection of desert rock formation, adventitiously passes within sight of the accident and drives over to investigate. T explains the situation and asks G to take him back to Tucson, which is sixty miles away. G replies that he will help only if T promises to pay him two-thirds of his wealth or $100000, whichever is more. T agrees, but after return to Tucson he refuses to keep his promise, and G brings an action to enforce it."

The relationship between G and T is bilateral monopoly i.e., a market which effectively consists of a single seller and a single buyer. However, the existence of a bilateral monopoly is not inconsistent with extremely disproportionate bargaining power. In this hypothetical case T is bargaining for his life, while G is bargaining for windfall profit. A bilateral monopoly characterised by extreme inequality of bargaining power can lead to inefficiency, because the stronger party can induce a price far in excess of cost. It is clear that a promise to pay an unfair price, extracted through the promisee’s exploitation of the promisor’s distress, should not be enforced to its full extent. The Common Law might have enforced T’s promise to its full extent, but the German Civil Code, Section 138 (2), Provides that a transaction is void "when a person (exploits) the distressed situation, inexperience, lack of judgmental ability, or grave weakness of will of another to obtain the grant or promise of pecuniary advantages... which are obviously disproportionate to the performance given in return". Prof. Eissenberg suggested that instead of voiding the contract or enforcing it to its full extent, the court should enforce T’s promise to G but only for the value of the services G rendered i.e., the opportunity cost of his efforts plus a bonus, say 20 per cent. The reason for including the bonus is that the fact that a court will award more than opportunity costs in these instances should provide a mild inducement to future rescuers to seek out and help stranded travellers.

31 Quoted in Ibid. p.755.

32 Ibid. p. 756.

33 Ibid. p. 756,757.
2. Transactional Incapacity

"An individual may be of average intelligence and yet may lack the aptitude, experience, or judgmental ability to make a deliberative and well-informed judgement concerning the disability of entering into a given complex transaction."\textsuperscript{34} The doctrine of transactional incapacity is not only limited to-the promisor lack of capacity to understand the value of the performances to be exchanged but also- to whether the promisor can understand the value of the performance called for but lacks capacity to understand the meaning of contractual provisions governing the parties’ rights in the event of non-performance. For example, in the well-known case of \textit{Williams v. Walker-Thomas Furniture Co.}, (350 F. 2d 445, D.C. Cir. 1965). The buyer frequently purchased furniture and home appliances from the seller on instalment credit, in which a contractual term called an ‘add-on’ clause was held to be unconscionable. These clauses provided that:

"the amount of each periodical instalment payment to be made by (purchaser) to the Company under this present lease shall be inclusive of and not in addition to the amount of each instalment payment to be made by (purchaser) under such prior leases, bills, or accounts; and all payments now and hereafter made by (purchaser) shall be credited pro rata on all outstanding leases, bills and accounts due to the Company by (Purchaser) at the time each such payment is made."

A single default on a single payment could trigger the plaintiff’s right to repossess all the goods subject to the comprehensive security arrangement.

3. Unfair Persuasion

It is that “the use of bargaining methods that seriously impair the free and competent exercise of judgement and produce a state of acquiescence that the promisee knows or should know is likely to be highly transitory.”\textsuperscript{35} For example, the well-known case of Odorizzi \textit{V. Bloomfield School District}, (246 Cal. App. 2d 123, 54 Cal. Rptr. 533, 1966). According to the plaintiff, Odorizzi, "an elementary school teacher, had been arrested of criminal charges of homosexual activity. After he had been questioned by the police, booked, released on bail, and gone forty hours without sleep, two school district officials came to his apartment. The officials advised

\textsuperscript{34} Quoted in \textit{ibid}. p. 763.  
\textsuperscript{35} Quoted in \textit{ibid}. p.772.  
\textsuperscript{36} Quoted in \textit{ibid}. p. 773,774.
Odorizzi that if he did not resign immediately he would be dismissed and his arrest would be publicised, jeopardising his chances of securing employment elsewhere, but that if he resigned at once the incident would not be publicised. Odorizzi then resigned, and the criminal charges were later dismissed. The court held that on these facts Odorizzi was entitled to reinstatement.”

“The doctrine of unfair persuasion can also be found in rules that a consumer who has made a contract in his own home can rescind during a specified ‘cooling-off’ period, typically three days”38. A major rational of these rules is that a consumer in his own home is subject to much more intense personal influence by the salesman than a consumer in the store: partly because it is often very difficult, in this marketplace, to break off the transaction; partly because the conventions of hospitality work against the consumer; and partly because door-to-door salesman often specialise in high-pressure selling techniques.

4. Price Ignorance

Price of goods and services are high in imperfect competitive market compared to perfect market because of non-availability of costless information about price. “A number of cases have concerned door-to-door sales at a price more than twice as high as that charged for comparable commodities in conventional retail marketplace”39. In the case of Toker v. Westerman (113 N.J. Super. 452, 274 A. 2d 78, Union County D. Ct. 1970), in which the “consumer had purchased a refrigerator-freezer for $899.98 plus a credit charges, whose sale value was apparently between $350 and $400”40. Consumer made payments of 655.85 and then stopped, and seller’s assignee sued for the remaining balance. The court held that the seller and his assignee had already received a reasonable sum, and gave judgement to the consumer, is mainly because of exorbitant price... which makes this contract unconscionable and therefore unenforceable.

37 Quoted in Ibid. p. 775,776.
38 Quoted in Ibid.
39 Quoted in Ibid. p.779.
40 Ibid.
The doctrine of unconscionability protects against fraud, duress and incompetence, without demanding specific proof of any of them⁴⁴.

C. Modern Theories of Consumer Protection

The ideology of modern theory towards to consumer protection is entirely different from the traditional theories of consumer protection such as the exploitation theory. It is not at taking into the account of the problem of consumer exploitation and the theory of unequal bargaining power regarding the arguments of the problem of consumer protection. Modern theory of consumer protection is basically arguing the case for consumer protection based on the problem of asymmetric information. Informational problems in between consumer and the producer for example, hidden action- the producer of a low quality product does not disclose the information to the consumer that his product is low quality and high probability risk.

I. Externalities

An externality, to quote Pigou’s (1932, p.183) classic discussion, “arises where one person..., in the course of rendering some service, for which payment is made, to a second person..., incidentally also renders services or disservice to other persons..., of such a sort that payment cannot be exacted from the benefited parties or compensation enforced on behalf of the injured parties”. Externalities arises from a lack of property rights, but at the same time, it is prohibitively costly to assign property rights for many goods and services, for example, common property resources. Jointness in production and consumption also leads to externalities. They may be negative e.g.: pollution, or positive e.g.: literacy; unilateral e.g.: the noise from a highway impinging on a residential neighbourhood, or reciprocal e.g.: pollination of an apple orchard by a honey producer’s bees.

Externalities are sometimes referred to as a divergence between private costs and social costs. And at the same time with the presence of externalities (technological and pecuniary) free-market will produce too much of goods with external costs and too little of goods with

⁴⁴The doctrine of unconscionability can be applied as well as in cases in which there has been, as a matter of fact, no consent by a party to certain terms contained in standard form agreements.
external benefits. Externalities may occur among households, producers and or between producers and households for example, in the case of pecuniary externalities, when a consumer enters the market for apples and places a large order, his additional demand may raise the prices of apples to all the consumers. Therefore, it may adversely affect their welfare. Externalities sometimes viewed as a 'mild' public good condition, market is unable to balance costs and benefits from a social point of view. For example, the exploding soda bottle may hit a passerby (consequential damages) and a failure by a doctor in treating a contagious disease may give rise to an epidemic. The costs of these product accidents fall partially on third parties, the relevant markets are likely to ignore some of the costs that use of these products entails. Neither the levels of product output nor the 'amounts' of safety built into the products themselves will be appropriately adjusted\textsuperscript{42}. In fact, the existence of externalities may affect either production or consumption and may perhaps lead to a reduction in welfare of the consumer in general.


In general, consumers have poor information about the price and quality of goods. It seems to be very difficult and also expensive for consumers to get the information on the quality of goods compared to the price of goods.

Nelson categorised the consumer goods into two types. They are 'search goods' and 'experience goods'. According to him, search goods are those in which dimensions of quality and safety can be ascertained in the search process prior to purchase, for example, furniture, hardware, glassware etc. In the case of search good the argument of consumer protection is not worth while because they may be fully aware of the characteristics of the goods either before purchase or at the time of purchase of goods. For example, in developing countries like, India majority of the food products are sold loose, which gives an opportunity for checking the attributes of the goods on the spot by the consumers and therefore, the traditional argument of 'consumer beware'. So, the classical theory of market perfection is perhaps very well suited or

\textsuperscript{42} Manufacturers and consumers might of course feel some remorse about the harm their behaviour creates, and thus act to reduce third-party risk. Few, however, would suggest that we rely on conscience to provide socially appropriate levels of safety. See Peter Asch, Consumer Safety Regulation: Putting a Price on Life and Limb, Oxford, Oxford University Press, 1988.
applies to the search goods. Thus, there is no need to protect the consumer in the case of search goods.

Experience goods are those that can not be fully determined before it is purchased, where quality refers to any valued attribute such as taste, efficiency, or durability. Most products are experience goods according to this description, for example, computer software, motion pictures, and most foods cannot be fully evaluated without consuming them. Durable products, such as automobiles are experience goods with respect to their post-purchase reliability and durability. The services of teachers, lawyers, are also experience goods. In the case of experience goods, consumers have lots of problems because they don’t know the characteristics of the goods at the time of purchase, but only come to know the characteristics of the goods while using the goods. For example, in the case of cement the quality will be known only while using it. Therefore, there may be enough scope for cheating of the consumer by the producer. In fact, if producer cheats the consumer and if at the same time consumer come to know that he was cheated by the producer, no market will exist. Thus, that the effect of consumer protection laws is not only to protect the consumer from the hazards but also to establish the conditions for viable markets for complicated goods.

A third category of good was developed by Darby and Karni, which is termed as ‘credence goods’. Credence goods are those that cannot be discovered even after purchase as the product is used. For example, it would be the claimed advantages of the removal of an appendix, which will be correct or not according to whether the organ is deceased. The buyer will have no different experience after the operation whether or not the organ was deceased. A layman does not know what has doctor served him. The only way is he has to believe the services of the doctor. But the commercial attitude of the doctors really raises the questions about the reliability of the doctors’ service. In an empirical survey in Switzerland, in all kinds of operations a lay man was advised by the medical surgeons to go for operation seven times.

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45 Ibid. p.69
higher than the fellow doctors were advised by the medical surgeons for operation. The problems of unnecessary operations and tests might prevail not only in absence of social security but also in the presence of social security, the only difference is that the cost of medical treatment will be diversified in the case of social security system but it is not the case in the absence of social security system. It is very complicated to regulate the credence goods and the protection of the consumer by way of private law is also not merely enough. Therefore, consumers need lot of protection in the case of credence goods.

The basic issue for a search good is product selection, for an experience good is information, and for credence good is information with a vengeance. For obvious reasons, the evaluation of qualities of goods is costly. As a result, monitoring becomes valuable and perfect competition fails as a viable form of market organisation. Especially, in the case of credence goods information is never obtained or obtained slowly and too late, for example, in the case of any chemical substance that causes cancer. Therefore, neither in the case of credence goods nor in the case of search goods but in the case of experience goods the protection of the interests of the consumer is well taken by the forces of the markets.

III. Asymmetric Information and Race to the Bottom

Each firm obtains market power under the assumption that the information is costly. Therefore, "the relevant market structure with imperfect information is not perfect competition but rather monopolistic competition". The efficiency of competitive market wills generally is based upon whether the decentralised decision-makers possess full information about the attributes of the products. The market mechanism itself plays an informational role by conveying information in the form of relevant prices to decision-makers about the relative costs and benefits of their different actions. Consumers equate perceived marginal benefit with the price. If they lack information, and then the perceived marginal benefit may not be equal to actual marginal benefit, which results in misallocation of resources. Consumers are unable to distinguish the quality of good and bad products, mainly because of the problem of asymmetric information.

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Asymmetric information in product quality may reduce economic efficiency from a hypothetical first-best level, but some allocational efficiency may be restored through legal intervention. The problem of asymmetric information was initially analysed by Akerlof (1970), by 'lemons' principle. According to this principle, the sellers have the better information about the quality of their products compared to buyers. And due to lack of information buyers will estimate the quality of the products on an average quality. It may result that the products of the above average quality simply go out of the market either because of they cannot receive the true value of the product or because of they can not even obtain the expected value of the new product. Therefore, the products which are less average quality will stay in the market and buyers will estimate new average quality which is less than the earlier one, and may perhaps leads to less and less quality products remaining in the market and so on. At one stage, no product will be traded at any price, accordingly, no market exists at all. This can be explained in the used car market, where good cars and bad cars (which is known as 'lemons') are traded. Normally, a used car may be a good car or a lemon. The buyers in this market purchase a new car without any idea of the quality of the car. But they do know that with probability of q it is a good car and with probability of (1-q) it is a bad car; by assumption, q is the proportion of good cars produced and (1-q) is the proportion of bad cars produced.

After experience with a specific car, the car owner can know the quality of his car i.e., he can easily assigns whether his car is good or lemon (let us assume his car is a lemon). So, if he is in the market- an asymmetry in available information has developed because the car owner has more knowledge about the quality of his car than the buyer has. And also good cars and bad cars must still sell at the same price because it is impossible for a buyer to tell the difference between a good car and a bad car. In such a situation, the sellers of the good cars will not have favourable market because they are unable to receive the exact value of the car (as well as unable to even obtain the expected value of a new car in order to buy a less probability of a 'lemon'). Thus, the sellers of good cars will be out of the market because the bad cars tend to drive out the good. The traded cars in the market will be the 'lemons'. At certain stage only

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bad quality cars exist in the market, which is referred as 'race to the bottom' or 'adverse selection'.

One can assume that the demand for used cars depends upon two variables, that is the price of the cars and the average quality of used cars. Therefore, the supply and the average quality of used cars will depend upon the price. And in equilibrium the supply must be equal to the demand for the given average quality of used cars. There is proportional relationship between the price and the quality i.e., as price falls; normally quality will also falls. Thus, it is quite possible that no goods will be traded at any price level, resulting in no market at all.

The 'lemons' principle of Akerlof goes far beyond the market for used cars. For example, the market for insurance, financial credit and even employment are also characterised by asymmetric quality information. The presence of asymmetric information between producers and consumers may result in collapse of the entire market system. From this, one can conclude that in markets for experience goods and credence goods, the system of contractual freedom and the absence of government regulation may result in non-optimal outcome so that for these type of goods regulation is necessary either by way of governmental interference into the market such as quality control, safety standards etc., or by a comprehensive system of liability rules within the civil law system. However, it may not be necessarily true, because there are certain institutions without consumer laws and legislations, which may solve the lemon problem.

**D. Market Induced Correctives of Asymmetric Information**

Before dealing in detail with legal remedies to cure the imperfections in the market which may result from the existence of experience and credence goods, it seems to be necessary to point out that within the markets some of these imperfections might already been cured. Especially in highly developed markets the existing institutions may perhaps cure some of the imperfections even without the help of the legal order. For example, the sellers of high quality products have a big incentive to convince the consumers that their goods have high quality by market signals and reputation.

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48 The principle of adverse selection is potentially present in all lines of insurance. When the term premiums are
1. Signal Theory

The concept of market signalling was first developed by Michael Spence, who showed that the sellers of high quality might send signals to consumers in such a way that it conveys information about a product quality.

1. Warranties

In general, “a warranty serves as both an insurance policy and a repair contract. In the case of insurance policy, a warranty provides that if, within a certain period, the product or some part of the product becomes defective, the manufacturer will compensate the consumer for the loss by repair, replacement, or refund of the purchase price. In the case of repair contract, a warranty fixes an obligation upon the manufacturer for some period of time to provide, without charge, services necessary to repair a defect in order to prolong the useful capacity of the product.”\(^{49}\). Warranties, not only provides insurance against unsatisfactory product performance but also may be a way for firms to communicate information about product quality. Warranties include replacement or repair of defective products, price funds and sometimes reimbursement for consequential damages. In fact, “a warranty is a commitment of the firm to replace a broken item during a specific period of time”\(^{50}\).

It is based on the assumption that without warranty, the low quality producer will offer his products at a price which is above his product costs but below the offer price of higher quality producer. Thus, at certain stage there is no market for higher quality products which leads to market for lemons. A solution to this problem is that the sellers of quality goods may induce the consumers through signals to think that their products are in high quality. The existence of warranties basically depends upon the three types of motives, the signalling motive is one among the three\(^ {51}\).

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\(^{49}\) Priest, n. 21, p. 1308.


\(^{51}\) The other two motives are: the insurance motive, which is based on the assumption that consumers are more risk averse than producers are. With different attitudes towards risk, producers provide consumers with insurance against the event of product failure in the form of warranty contracts; the incentive motive, which
A producer of a high quality product can provide additional unit of warranty at a lower cost than a producer of a low quality product. It is mainly because of the 'break-down' probability of good quality product is lower than the 'break-down' probability of a bad quality product. When a high quality producer offers extensive warranty coverage, a low quality producer is unable to mimic the signals because of huge losses. This can be explained with the help of a graph 1.1.

**Graph No. 1.1**

Warranties as a Device for Providing Information about Product Quality

![Graph](image)

- \(W\) = Warranty
- \(C(q_h)\) = Cost of high quality Products
- \(C(q_l)\) = Cost of low quality Products


The constant value of \(C\) at the vertical axis represents the production cost and price in a competitive market for a low quality and a high quality product so that the consumer has no possibility to know whether a product is of high or low quality. The slope of the curve views warranties as an incentive devices for firms not to cheat on quality. By lowering the quality level, the firms increase the probability of product failure by higher warranty cost. Therefore, warranties provide producers as an incentive to supply high quality products. Winand Emons. The Theory of Warranty Contracts”, *Journal of Economic Surveys*, Vol. 3, No. 1, 1989, pp.44, 45.
represents the costs of increasing marginally the value of warranty contracts for the consumer. The warranty contracts are modelled in such a way that the value of one is the maximum warranty (money back) and that a value of lower than one is a warranty contract which gives the consumer less than the full money back guarantee. The non-linear curve touching the warranty contract line at $W - 1$ is an indifference curve of the consumer.

The figure shows that, "some firms produce a high quality level $q_h$ and the other firms produce a low quality level $q_l$. Since $q_h > q_l$, a high quality producer can offer an additional unit of warranty at a lower cost than a low quality producer"\textsuperscript{52}. If a high quality producer offer a warranty $w > w^*$ at the fair-ads rate $(1-q_h)$, a low quality producer mimicking his signal would incur losses, because the failure probability of his product is higher. And at the same time, whenever consumers observe a warranty $w > w^*$, they know that they may face a high quality product because producers have no incentive to cheat on quality.

Priest (1981), examines whether the exploitation, signalling, or investment theory best explains the content of 62 consumer product warranties. He finds that among the three theories under study the investment theory\textsuperscript{53} is best suited to explain the actual design of warranties. Without warranties it is high quality products and with warranties it is low quality products, which get driven out of the market.

2. Advertisement

Advertisement is undoubtedly the provision of information concerning the prices and qualities of products available in the market. "Firms using advertising to inform potential consumers


\textsuperscript{53} \textit{Ibid.} p. 55. According to Priest, warranty serves a role of repair investments besides that of reducing transaction costs. By tying the warranty to the sale of the product, it also operates as performance bond of the manufacturer, see Barzel (1977). The decision to allocate repair investments between the manufacturer and the consumer, however, is identical to the decision of who should bear typical repair costs. As a more general proposition, however, two forms of investment by consumers will affect the likelihood of defects in any consumer product- (a) the consumer's selection on a product suitable for his expected needs; (b) the consumer's decision about the extent to which he will use the product. According to investment theory, a manufacturer makes incentives to prolong product life up to the point at which the marginal cost of such investment equals the marginal benefit. A manufacturer, then, offers market insurance for those losses or items of service for which market insurance is less costly than insurance or allocated investments by the consumer himself. See: Priest, n. 21, p. 1312, 1313.
about the existence, characteristics, and prices of the commodities they offer." Nelson (1970, 1974a, 1974b, 1978) has suggested that the primary message of advertisement is a positive message to prospective consumers." In such a case, the consumers are expected to infer an unobservable quality from an observable advertising i.e., advertising signal quality.

A Positive Relationship

In the case of an experience good, when a particular brand was advertised it could be a signal to consumers that the brand was high quality. It is clear that if high quality brands advertise more and advertising expenditures are observable, then rational, informed consumers would respond positively to the advertising, even if the advertisement cannot and do not have much direct information content. In India, one can easily observe the producers of cement spending enormous amount on advertising in order to establish their market though by way of reputation. The expenditure on advertisement is a kind specific investment or sunk cost, of firm if they wants recover all these costs they have to stay in the market and if they want to stay in the market they should not cheat the consumer in terms of product quality. However, the alternative for many producers with low firms specific fixed costs is to enter the market, sell cheap or hazardous quality and then leave the market at no cost, which is termed as hit-and-run strategy. The costs of advertisement for this type of producers may grossly reduce the profitability of a hit-and-run strategy.

Therefore, consumers are expected to infer that higher quality firms invest relatively more on advertising than do lower quality firms and vice versa. Advertising may signal quality, but


55 Ibid. p. 797.

56 The advertising campaign for the 1984 Ford Ranger truck, which featured these trucks being thrown out of aeroplanes (followed by a half dozen sky drivers) or driven off high cliffs. It given the information that the product is existing in the market, and also the clearest message they carry is, we are spending an astronomical amount of money on this ad-campaign. Ibid.

57 Nelson's fundamental point concerning the role of advertisement is that, its inclusion of the pricing decision upsets the intuition that a high-quality producer will have a higher marginal benefit from attracting an initial sale and that this would provide the basis for the high quality firm's being willing to advertise more, up to which that low quality firm's will not mimic. Ibid. 797, 798.
price signalling will also typically occur, and the extent to which each is used depends in a rather complicated way, inter alia, on the difference in costs across qualities".\(^{58}\)

b) Experimenters

Advertisement works as a signal by way of attracting the attention of consumers who can be treated as experimenters. Johnsen (1976), some consumers are experimenters who will buy a product if a sufficient amount is spent on advertisement. If these experimenters find the advertised product to be of high quality, they recommend it to imitators, who substantially buy it. These types of advertisements by the producer of high quality product leads to repeat sales but advertisements by the low quality producer does not. For this reason only the producers of high quality products advertise and advertise signal quality.

"Advertisements increase consumer satisfaction because of the pleasure derived from advertisements and also by promoting the sale of branded goods, it makes for great convenience of shopping".\(^{59}\) In order for advertising to be an effective signal, "high quality firms must be able to recover advertising costs while low quality firms can not".\(^{60}\)

3. Price Signals: Product-Specific Information

The role of prices in conveying information in the case of asymmetric information was first explained by Grossman-Stiglitz (1976) and Kihlstrom-Mirman (1975).\(^{61}\) In a market for a product that can be produced at different quality levels, but higher qualities are more costly to produce, the produced quality will be known only to the producer of that product. And all the consumers prefer higher quality product to lower quality product, but they may vary in their willingness to pay for quality products. Under these circumstances, prices may serve as signals which exactly differentiate the available product quality levels. Normally, for a certain product

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\(^{58}\)Quoted in Ibid. P.819.


\(^{61}\)These are the models of financial markets in which demands of informed agents influence asset price. Uninformed agents extract this signal from the price in formulating their own asset demands.
price consumers are "expected to find a certain product quality. A firm that charges that price may produce a lower quality product, but the product-specific information will enable some potential consumers to find out this, and provided that there are competing offers, they will not buy from that firm"\textsuperscript{62}. Therefore, in deciding whether to produce a lower quality than that signalled by its price is depending upon how a firm weighs the loss of sales against the cost saved of the sales to the remaining consumers? If the mark-up over the marginal cost of producing the quality signalled by the price is sufficiently high, the loss of sales will outweigh the cost saved. In that case, it is better for the firm to produce the quality signalled by price. At equilibrium, all price-signals are such that each firm's profit-maximising quality is that signalled by its price\textsuperscript{63}.

II. Reputation: Consumer Learning

1. Repeated Purchases

Reputation is a word which denotes the persistence of quality and it commands a price (or exacts a penalty) because it economises on search\textsuperscript{64}.

In an asymmetric environment, "it is difficult to determine the quality of the product before purchase, and firms have an incentive to sell low quality products at high quality product prices. Klein and Leffler (1981) have suggested a competitive model where firms that produce low quality products and sell them at high quality prices acquire a bad reputation and are excluded from the market"\textsuperscript{65}. By experimenting, consumers learn the attributes of a product. As long as their current experience is somehow related to the future quality, they obtain valuable information as to whether should repeat their purchases.

\textsuperscript{62}Some information about the quality of a firm's product will, however, reach its potential consumers, even if they do not make any special effort to acquire it.


The producer of a high quality product try to induce consumers to buy his product by way of an introductory offers\textsuperscript{66} At an introductory period producer of a high quality product may charge low price in order to attract the consumers. But the consumers think that a low price may indicates a low quality. However, based on the assumption that a high quality product generates repeat purchase So, that the producer of high quality product may more willing to sacrifice current profits to attract the consumers. The Producer of a low quality product may not will to duplicate this sacrifice because consumers are not worth as much to him. Hence, under certain circumstances, a low price may be signalling the quality, which is high. Once the consumers are informed, the producers of high quality products may charge high price and at the same time they have incentives to provide higher quality products because they are more afraid of loosing consumers.

2. Communications among Consumers

In order to induce the producers of high quality product; repeat purchases may need not necessarily made by the same consumer. Even in the case of one shot-good, the producers of the high quality product may have more customers because they have fewer dissatisfied consumers who leave, and word-of mouth advertising results in more arrivals. For example, one may deal with a real-estate agent or a contractor infrequently, but may learn about the quality of their recent services through family or friends. Intermediaries like, news papers, shopping guides, designers, doctors, attorneys, real estate brokers and consumer reports may provide more specific information tailored to the particular needs of the consumer and it can have significant effects on market outcome\textsuperscript{67}.

Quality deterioration because of asymmetric information depends upon how the consumers will learn the quality of a purchased product, sufficiently and quickly. Since the producer incentives to provide a high quality product will mainly depend upon the consumers learning, the process by which consumers gather information is crucial. One way to incorporate learning into consumer choice is to assume that the quality is positively related the probability of repeat

\textsuperscript{66}Farrel (1984), define an introductory offer as a first-period price that is strictly lower than the second-period (full information) price times the first-period probability of the customers' liking the good.

purchase. According to Shapiro, at any point in time each consumer will have some expectations regarding product quality. These expectations constitute the quality of goods' reputation. Consumer learning then involves adjusting expected quality towards true quality. In the case of unobservable product qualities even after consumption, will result in lagged adjustment of consumer expectations.\(^{68}\)

E. Reasons for Limitations of Market Induced Correctives of Asymmetric Information

I. Incomplete Warranties

Signals, however, only reduce information costs to consumers. But with some consumers misperception of product risks is inevitable.\(^{69}\) The extent of misperception is determined by the costs and benefits to consumers of obtaining product information by means of warranty signals. Dean Prosser (1943) argued that, "without judicial intervention to imply warranties of quality in sales transactions, many manufacturers would provide consumers with worthless junk."\(^{70}\)

Incomplete information from consumer's side may prevent warranties from serving the basic motives in a first-best way. The problems of moral hazard and adverse selection may prevent efficient risk sharing between the consumer and manufacturer.

1. Moral Hazard

In Arrow (1963) and Pauly (1968), the usual approach to the problem is to regard the existence of insurance itself as encouraging the purchaser to use too much of the good or


service that the insurance supplies. The essence of this argument is that once an individual has taken out insurance against some particular contingency, the incentives to act in ways that decrease the risks involved will be reduced. For example, a home owner who is fully insured against burglary could be inclined to increase the size of the potential loss, by holding more valuables in the home, and probability of the loss, by spending less on locks and other burglary prevention devices.

Milgrom and Roberts (1992 P. 456), says that moral hazard is the 'form of post contractual opportunism that arises because actions that have efficiency consequences are not freely observable and so the person taking them may choose to pursue his or her private interests at others' expense'. And also consumers may exert some influence on the probability of a product failure, by the way in which they handle the product. If the action chosen by the consumer cannot be monitored, producers providing warranties may face a moral hazard problem. For example, in the case of washing machine, it is impossible for the manufacturer to monitor intensity of use or maintenance. Usually, the more warranty that the buyers get, the less incentives they have to avoid the event of product break-down. It is because of moral hazard, that Shapiro (1983), ruled out warranty as a quality assuring mechanism.

2. Adverse Selection

Adverse selection may result in a rationed indemnity. In general, producers of a product face two groups of risk-averse consumers. Due to exogenously given differences in the consumer's characteristics, the product's breakdown probability may be lower when it is used by low-risk consumers than the product's breakdown probability when it is used by high-risk consumers. If firms can perfectly discriminate between two groups of consumers, they will offer warranty coverage at the premium-benefit ratio for low-risk consumers and at the fair odds rate for high-risk consumers. In some cases either firms are unable to distinguish between these two groups of consumers or firms are unable to find out the cause of product failure, whether it is because

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of high usage or because of random failure. In such situation, firms may invariably end up with limited duration of warranties. Similarly, in the case of warranty coverage, also low-risk consumers prefer lower warranty coverage and the high-risk consumers will buy complete warranty coverage. In the case of small population of low-risk consumers, the possibility of arriving at an appropriate coverage trough separating equilibrium becomes very difficult. Therefore, firms prefer a warranty which is based on pooling equilibrium, which is unfair to low-risk consumers, since they end up with cross-subsidising high-risk consumers. Thus, the problem of adverse selection results in an inefficient system of warranties.

II. Deceptive Advertisement

Advertisements often fail to inform consumers and in addition raise expectations beyond what can be fulfilled by a product or service. Advertising is both the major medium of information for consumers and the major method of misinformation. In reality, the wants of consumers are being manipulated by advertising, so that instead of industry producing what the consumers want to buy, consumers are being duped and brain washed into buying what industry wants to sell. A deceptive advertisement is one which makes a false statement about the product, for example, 'our product will cure baldness', when in fact it will not.

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73 Firms offer two distinct warranty contracts, High-risk consumers purchase will complete warranty at their fair odd rate and the low-risk consumers will purchase the warranty level at their fair odd rate.

72 Firms offer the warranty at the average breakdown probability, low-risk consumers choose the warranty level which is less than the complete because the premium-benefit ratio is unfair to this group. High-risk consumers also buy this warranty level in order not to reveal their identity.


77 an advertisement is deceptive:

i. If it makes a false claim about any material fact, that is an advertisement may be literally true, but still lead many consumers to draw false inferences about the product, with the same effect (as far as those consumers are concerned) as if the false inferences had been stated explicitly, for example, 'no product is more effective in curing baldness' (true, if all are equally ineffective) or that the product 'kills bacteria which cause baldness' (true, but incorrect in case of hereditary baldness);

ii. If it produces an inaccurate belief in any material fiction (some) consumers, that is falsity of the words of advertisement, which caused false belief, for example selling recycled oil without disclosing the fact that it has been recycled or imported products without disclosing that they were not made in India. Advertisements
Advertisement is simply a conspicuous expenditure incurred by firms. It is a fixed cost, which brings no direct benefit to the consumers. Further, Advertisement could prove deceptive but it is difficult to prove the false advertisement of quality. It is also increases the power of monopoly, with all its evils, creates a false sense of values and leads to a constant tendency for actual satisfaction to fall short of expectation, generally, that it leads to inefficient distribution by consumers of their expenditure. According to Retail Standards Association, 'it is quite possible to write an advertisement which is wholly truthful, yet totally misleading'.

III. 'Rip-Off' Uninformed Consumers

Consumers use prices as a signal of quality. In the Kihlstrom- Mirman and Grossman - Stiglitz models, suppliers of the asset cannot respond to the behaviour of the uninformed agents. Therefore, rational expectation equilibrium will reveal the information of the informed agents. So, prices convey information about the product quality from informed consumers to uninformed consumers. Once uninformed consumers use prices as signal of quality, profitable opportunities may attract for the entry of firms selling low quality products at high prices to the uninformed consumers. In such a way, dishonest firms may enter and 'rip-off' uninformed consumers. And also, it may distort the information conveyed by product prices i.e., price itself is a poor indicator of quality.

have been treated deceptive, even when only 10 or 15 per cent (or possibly even less) of the consumers who saw the advertisement might have formed the incorrect belief;

iii. If it leaves (some) consumers with inaccurate beliefs about any material fact, that is if the advertisement fails to correct a pre-existing false belief. And also, if disclosing the additional information change the consumers behaviour, then his previous uninformed behaviour must have been based on a different (and hence incorrect) prior belief;

iv. If it fails to disclose any information which would change (some) consumer's behaviour, that is a consumer will be deceived as long as he does not have accurate information on every material point, or as long as there is still additional information the seller could disclose that would bear on the purchase decision.

v. If it fails to disclose the information that would be optimal under the circumstances, that is very much in need to understanding of consumer information markets than is reflected in current legal doctrine". See Hoard becles, Richard Craswell and, Steven C Salop, "The Efficient Regulation of Consumer Information", *Journal of Law & Economics*, Vol. 24, No. 3, December 1981, pp. 496-501.

IV Non Repeated Purchases

Repeated purchases induce the producers of the high quality products not to cheat the consumers under the condition that the consumers repeat their purchase sufficiently. In that case producers have fear that consumers cut off their relations with them in the case of opportunistic behaviour. If the gains from opportunism are smaller than the loss from the exit option of the consumer opportunistic behaviour will not arise. However, in the case of durable products, the consumer's gross surplus is fixed as long as the product works. Quality is then measured by the amount of time between purchase and breakdown of the product. In such a situation, where the product durability is high, reputation seems to be less effective because of one-shot purchase. Therefore, durable products generate fewer repeat sales compared to less durable products. In the extreme case, a product that never breaks-down does not generate repeat sales. Hence, the producer may not have any incentives to produce durable products.

V Little Communication Among Consumers

Information dissemination among consumers by way of intermediaries may not work effectively. By the very nature of the transaction, the consumer is often unable to judge the quality of the service received. Some times scale of economies in information generation and dissemination leads to natural monopoly problems; information intermediaries can achieve a high level of market power\(^7\).

Information has public good properties. The production, purchase and use of information by consumers generate a market-perfecting external benefit to uninformed consumers. Additional information induce producers to compete for the patronage of informed consumers by offering better value, either by lower prices with higher qualities or by better contract terms. Although perfect market does not require all consumers to be perfectly informed, this externality implies

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\(^7\)Even in the absence of natural monopoly, legislatures sometimes create this power in various regulations and statutes. For example, local building codes often require building materials to be certified by one or more specific standard setters rather than simply that materials achieve a performance level equal to those standards. In these cases, the standard setters can have the power to deter competition by arbitrarily preventing new entity and setting inefficient standards. For instance, standard setters often formulate arbitrary design standards (i.e., pipe must be copper) rather than performance standards i.e., pipe must withstand xpsi of pressure. This may act to deter or delay innovation.
that too little product information will generally be produced, even in an otherwise competitive information market. The shortage of third party information providers may also lead to an undersupply of information.

VI. Consumers Misperception: Low Probability Risks

Consumers have some expectations regarding product quality even in the presence of asymmetric information. Spence (1977) assumes that consumers systematically overestimate the probability that the product will not fail. The producer, who has rational expectations, then gains from offering a low warranty for a low price. The consumers are willing to accept this contract because they wrongly perceive the probability of failure as low. In turn, this low warranty induces the producer to undergo supply reliability.

VII. No Asset Specificity

Neo-classical transactions take place within markets where “faceless buyer and seller ... meet...for an instant to exchange standard goods at equilibrium prices”. Exchanges that are supported by transaction-specific investments are neither faceless nor instantaneous. Asset specificity arises only in an intertemporal context. Williamson categorised four types of asset specificities. They are (a) site specificity; (b) physical asset specificity; (c) human asset specificity, and (d) dedicated assets.

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81There are two factors- one is natural monopoly i.e., produced information can be disseminated at low marginal cost; and the other is free rider externalities i.e., buyers can resell purchased information to others.


83In regard to consumers underestimating risks, Calabrisi (1970), remarked, ‘such things always happen to the other guy’ is common. In particular instances, such proclaimed misperceptions may be due to cognitive dissonance; i.e., they may be ex-post attempts to justify the agent’s behaviour (carelessness, signature of incomplete contracts etc.); this should be investigated.


85Site specificity, for instance, successive stations that are located in a check list-by-jowl relation to each other so as to economise on inventory and transportation expenses; physical asset specificity, for example, specialised
Assets are specific or non-specific and what its implications are can be explained by way of an illustration. A firm which is investing in car production, due to some reasons the firm went bankrupt. The creditors of that firm can get some part of their investments by way of selling fixed assets of that firm or by way of next best use. It is not possible in the case of assets which are related to specific investments, for example, in the case of Euro-tunnel, the creditors will get nothing in case of closing the Euro-tunnel, because there is no possibility of next best use. In the view of consumers, they will benefit if and only if, the investments are related to asset specificity. The existence of high firms specific capital makes opportunistic behaviour non-profitable. If transactions are not related to asset specificity, there are n number of producers enter into the market, whose behaviour is just like 'hit and run'. These types of producers will stay in the market only for windfall gains. In such an environment, the market-induced correctives may be less effective.

F. Consequences of Consumer Protection in Well- Defined Solvents of the Market

Consumers are effectively protected if the markets work perfectly, even in the absence of any consumer protection laws. Theoretically, economists assume that the consumer is a rational maximiser of satisfaction and that the market operates as an influence on manufacturers. Competition among producers may curb misleading trade practices, if consumers are milled on one accession. Even in the case of standard form of contracts, if the seller offers unattractive terms to consumers, competitors will come forward with better terms. Therefore, the consumer who is offered a printed contract on the basis of take-it or leave-it does have a real choice, he can refuse to sign, knowing that if better terms are possible another seller will offer them to him.\textsuperscript{86}

Introducing the consumer protection in a well functioning price mechanism may lead to adverse effects. And also by diminishing an opportunity of voluntary exchange may result in reducing the economic welfare. In a highly regulated market, the cost of regulation as well as the increased cost of production will be ultimately paid by the consumers. The unorganised group of consumers may be unable to influence the legislatures compared to organised group of producers because of free rider problems. Price mechanism may reduce the information costs about what degree of product liability is economical because consumers are in a better position than any other regulatory agency to know the exact uses they plan for products and what degree of quality is appropriate.

G. Differences in the Market Conditions and Applicability of Conditions of Correctives

I. Developed Markets and Spontaneity of Corrective Institutions

Markets in developed countries, like Germany, may work effectively either because of competition among producers or because of awareness among consumers about their rights and obligations in the market place. For example, in the case of warranties, it seems to be easy to compare the available standard form of contracts and accordingly consumers may accept or reject the warranty. And even in the case of reputation, the consumers of developed countries may learn very quickly and sufficiently about the quality of the products signalled by the producers of the high quality products, which may perhaps give an incentive to the making of quality products by the manufacturers.

In developed markets, the consumers judge the quality of the product accurately with the available information and at the same time, the unfair trade practices may be found quickly and may send out of the market place at an earliest possible time.

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However, even in the case of well-developed markets, the protection of consumer interests may still be an high priority because of the nature of goods i.e., credence goods and experience goods. For example, in mad cow disease in Europe, the market is unable to correct itself from the supplying of bad quality meat because of informational problems.

II. Less Developed Market Conditions and Problem of Persistence of Deficiencies

In markets in less developed countries, like India, competition may not be revealed among the producers because of monopolisation of resources. Consumers are unable to learn very quickly and sufficiently the quality of the product signalled by the producer of high-quality product, may not be understood due to lack of awareness, which results that the reputation may not be effective. For that matter, the reputation via the market is a very sophisticated and complicated institution of a developed market system. If the market system is introduced in a developing country, reputation may takes a long time to develop for internal producers. Therefore, the scope for opportunistic behaviour on the side of the producers is very high and calls for the quality regulation and product safety by way of ex-post and ex-ante approach may be much higher in less developed markets rather than highly sophisticated markets. Since much of the goods and services are scarce, the consumers don't have any choice to select them according their tastes and preferences, under such market conditions the principle of take-it or leave-it may prevail pretty well. Therefore, the consumers are unable to get better warranty contracts.

The consumers of less developed markets really lack information about the available goods or services and at the same time they are also unaware about their rights and obligations in the market place. There are possibilities that the market may not simply develop for experience goods. In general, purchase of foreign goods may be a prestige, but rational consumers may buy the foreign goods because of their reputation compared to the domestic products. For instance, German based Bahlsen company biscuits have reputation in Russian consumer product market in spite of three times higher price than the domestic biscuits.
11. Role of Consumer Protection under Different Socio-economic Contexts

India is basically an agrarian economy and more than 60 percent of people live in villages. In such an economy the needs of consumers are few, and these are met through exchange of goods and services with a self-reliance. With the transition from agricultural green-revolution (for instance, food production of 182 million tonnes*), to industrial revolution (growth rate of 5 1 per cent*), the state of affairs has changed drastically. In spite of all these developments, still she is under the category of developing nations with lower per capita income i.e., RS. 2282 at 1980 prices* (Human Social Index). Rapid growth of population (920 million in 1995) misutilisation of resources due to lack of know how and existence of distributional inequalities may have direct or indirect influence on unemployment, illiteracy (merely 50 per cent of the total population don’t know how to read and understand, as per 1991 census) poverty (merely, 40 per cent of the people fall below poverty line) and scarcity of goods or services.

The new economic policies and the agreement of GATT, puts the Indian consumer in a much weaker position in terms of bargaining power with the producer. The entry of MNCs may increase consumer choice, but the incentive structure of MNCs regarding providing quality and safety products are doubtful. It may be either because of consumers incapacity of quick learning of MNCs product signals about their high quality products or because of being unaware of their rights and obligations in the market place. Consumers are exploited by the producers in almost all respects, simply not only because of their ignorance or illiteracy but also because of many consumers unable to afford the time which it involves and may have nagging uncertainties with regard to the merit of their grievances and may others, in spite of their frustration and dissatisfaction, do not wish to press their claims. Consumers may also have hardly and choice because of non-availability of sufficient goods or services and the available goods being either high price or manipulated, which may results to little scope for complaint by them of quality and measures.

The producers in India can easily distinguish the consumers, marginal and infra-marginal consumers. They may provide quality goods and better contracts terms to marginal consumers and rip-off the infra-marginal consumers by providing low quality products at high prices. With prevailing socio-economic conditions of consumers, it is necessary to have a strong consumer
movement in order to strengthen the socio-economic and legal measures of consumer protection.

In a mixed economy, like India, the public sector plays a major role in providing the goods or services to the consumers compared to the private sector. The public sector industries, like electricity, water, telephone, postal services, and air & road transportation etc., play predominant role in providing services to the consumers. And also through public distribution system, state is providing essential commodities viz., rice, wheat, sugar, edible oil and kerosene to rural and urban poor at subsidised rates.

In India, the market system is not as highly developed as in Europe and that therefore the scope for opportunistic behaviour is greater because the institution of reputation is less developed. The degree of asymmetric information is very high in a country like India rather than in a country like Germany because of 50 percent of illiteracy and a less financial means. In India, the degree of monopoly power of producers seems to be much higher than in Europe or in the United States. These countries are completely open economies. Therefore, monopoly power can arise only in certain pockets where the degree of regulation is high, such as banking and insurance. Therefore, the traditional exploitation theory of consumer protection even though not a valid theory to explain the necessity for consumer protection in Europe might have some relevance in a case like India.

The consumers have grievances about the goods or services, provided not only by private sector but also by public sector. According to the developed theoretical arguments of state intervention in order to protect the interests of the consumer, the state can protect the consumer either by way of liability system or by way of regulatory system or by both. In the case of defects and deficiencies of goods or services provided by the private sector, the state can use alternative systems or both the systems but in the case of state provided defective and deficiency goods or services, the regulatory agencies may have little grip compared to liability system, to protect the interests of the consumers.

88 The industrial policy 1991, envisaged disinvestment of a part of government holdings in the share capital of selected Public Sector Enterprises (PSEs) in order to provide market discipline and to improve the performance of Public enterprises, RS 4950 crores disinvested till March 1994. Transition from no-loss and no-profit condition (public sector) to profit maximisation condition (private sector) may suggest strong consumer protection through state intervention either by way of liability system or by way of regulatory system and or by both the systems.