DOES THE WINE INDUSTRY SELL LEMONS? THE ADVERSE SELECTION PROBLEM APPLIED TO WINE BRANDING

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Abstract

How much information does the buyer and seller in a transaction share? Economic theory suggests, after decades of modeling perfect information, few transactions actually have equal information and markets are inefficient as a result. Akerlof (1970), Stiglitz and Weiss (1981), and Shapiro and Stiglitz (1984) applied imperfect information modeling to the insurance, credit and labor markets respectively. The idea that there exists an information breach between buyer and seller can be as simple and obvious as having monopoly power (petroleum sales), and as complex as selling potatoes next to ten other producers at a farmer's market. The science of marketing is based upon product differentiation and the returns therein. The wine industry provides debatably the world's largest breadth of products that use similar packaging with label and logo differences as primary to their marketing efforts. While there have been studies of wine labeling, marketing, and sales, this paper focuses on the specific dilemma faced by the consumer and retailer: how does the consumer know she is buying a high quality wine ex ante?

The wine industry, more than any other beverage market, uses quality in multiple ways to differentiate products. It could be simple statements as advertising slogans, or expert opinion by professional tasters. In contrast, in non-alcoholic soda markets, branding rules product differentiation. National campaigns exist in soda for goods such as Coke and Pepsi, and these two products acts as duopolists and the highest quality in their market. Both goods come from conglomerate firms that spread their advertising expenses over many products and industries. The wine industry does not have that luxury in many instances, and in fact may have the reverse problem. One myth in the wine industry is the more widely recognized the wine brand, the lower the perception of quality. Wine quality is truly in the mouth of the beholder; wineries must signal quality to

customers, and do it in many ways. When they do it right, wineries reduce the adverse selection problem for customers and reduce advertising costs without reducing price.

To what extent does the adverse selection problem exist in the wine industry? This paper first defines the adverse selection problem in this industry. The wine industry has many firms selling at multiple price points using branding and marketing as the thrust in sales. Two large challenges for this industry are mitigating the adverse selection problem, making the wine choice easier for consumers by recognizing that wine consumers may see wine advertising as non-accessible. This inaccessibility typifies the adverse selection problem. Phenomena such as signaling can take place in retail establishments as well as in third-party publications, such as the Wine Spectator, the Wine Advocate, and internet sites. This industry provides a great test of adverse selection in marketing and consumer purchases, and whether signaling efforts provide the industry any additional profitability.