

Quality Theories in Agricultural Economics

Peter Bowbrick

ABSTRACT

This paper analyses the usefulness of economic theories of quality based on the assumptions of Rational Economic Man. It is shown that they have little value in analysing real world products in real world markets, and are of little value in agricultural economics.

European Association of Agricultural Economists
Meeting on Product Quality
Wageningen University
Netherlands
March 1996

QUALITY THEORIES IN AGRICULTURAL ECONOMICS

PETER BOWBRICK¹

INTRODUCTION

With agricultural products it is particularly clear that quality is important in determining price and even market structure, and for this reason agricultural economics was the first to develop the economics of quality, starting with the hedonic approaches following from Waugh (1928). Most of these theories are based on the realities of agricultural products in agricultural markets. There is, however, another set of theories which is based on the assumption of rational economic man (REM) making optimal choices between goods on the basis of the objective characteristics of these goods, with perfect knowledge about the level of these characteristics and their prices. Some REM theories, such as the characteristics approach, come directly from the agricultural economists' normative models for mixing animal feeds (Stigler, 1945; Gorman 1956), using them as descriptions of how rational economic man behaves. The seminal REM papers are Lancaster (1966, 1971, 1979),² Rosen (1974), Leland (1977), Ladd and Zober (1978), Ratchford (1979), and in a rather different vein, Houthakker (1952), Thiel (1952), Brems (1948, 1957). There are now well over 10,000 papers in this research tradition which depend crucially on the fundamentals laid down in the seminal papers even though additional assumptions and a long chain of logic means that the theory may look very different at first glance. These dominate the mainstream economics approach to quality and are also important in agricultural economics and marketing.

In this paper the REM theories are examined at a fundamental level in order to identify weaknesses common to the whole REM research programme. Repeated reference is made to Lancaster because he provided the logical foundation for the research programme and his analysis is detailed, clear and rigorous. His work is the most cited in the economics of quality and, indeed, his 1966 paper is one of the most cited in economics.

It will be shown here that the fundamental assumptions are not simplifications but conflict with observed reality. The boundary assumptions and *ad hoc* assumptions are so restrictive as to forbid any real life situations. Conceptual and logical errors mean that the conclusions do not follow from the assumptions. It is formally impossible to test the theories by their predictions and no attempt has been made to do so. This combination of weaknesses is fatal under any of five very different epistemological approaches used by economists. These weaknesses are at a very basic level so they affect all theories and models sharing this common basis of assumptions, concepts and logic.

This paper does not present any alternative to REM theories of quality, because there are already many established and in general use. There are, for instance, the hedonic approach, compensatory models, perceived quality, behavioural, behaviourist and heuristics approaches and the composite and complex approaches of agricultural marketing economics (e.g. Bowbrick, 1992) and the new mainstream economics (e.g. Earl 1986). One may weed the garden without first breeding new orchid hybrids.

¹ Peter@Bowbrick.eu

² Becker (1965), Muth (1966), Ironmonger (1972) and Gorman (1956) produced similar theories but without Lancaster's rigour of analysis of fundamentals these had little impact.

FUNDAMENTAL ASSUMPTIONS

In agricultural economics it is normally held that theory must be based on assumptions that are both realistic and non-trivial. Some simplification is necessary and, indeed, desirable, but assumptions contrary to observed reality are not acceptable. If trivial or unrealistic assumptions are used, an infinite number of theories can be generated, and it would be absurd to test the predictions of all such theories, as there is no reason to believe that they will be good predictors. Such theories are not normally included in the canon of agricultural economics. (Some less common epistemological approaches are discussed in the final section of this paper).

The fundamental assumptions are ones that cannot be changed without reworking the theory from the beginning. In the seminal papers that set out the foundations for the research programme, it is not possible to get beyond the first stage of the analysis if these assumptions are changed. With those papers published today, which build a long chain of analysis from these fundamental assumptions, the conclusions can be changed radically if there is even the slightest change to the fundamental assumptions - 'for the want of a nail a kingdom was lost'. It is not necessary to drop the assumption or change it radically

The common fundamental assumptions of the REM research programme are on a) consumer preferences, b) characteristics space, c) supply price and d) objectivity. Theories develop in many different directions from these fundamental assumptions, with different further assumptions, boundary assumptions and *ad hoc* assumptions.

Assumptions on Consumer Preferences

REM theory is concerned with 'characteristics', which are the objective properties of goods. A good is a unique mixture of characteristics, so one combination of colour, seedlessness, juiciness, sugar and acids makes the 'good' Washington Navel Orange. Oranges in general are a 'group of goods'. The theory is not concerned with an individual's subjective preference or 'attributes'. The research programme assumes that each consumer always prefers a good with more of at least one characteristic, so that an indifference curve between two characteristics in characteristics space looks like the traditional indifference curve between two goods in goods space (Figure 1). This fundamental assumption has been formalized by Lancaster (1971, p26) who shows that it is necessary to assume transitivity, completeness, continuity, strict convexity, non-satiation and all characteristics positively desired, in order 'that the consumer's preferences can be expressed in terms of an ordinal utility function of the neo-classical kind with all its first order partial derivatives positive'. The intention is to 'simply carry over traditional preference theory, applying it to collections of characteristics instead of collections of goods'.

A basic conceptual error arises here, as a result of applying theory appropriate to *goods* to a completely different situation, *characteristics*. In standard economics we are talking of two goods which may be bought separately to be consumed separately, steak and ice cream, or bread and wallpaper, for instance. When we are talking of quality, the characteristics are necessarily bought together and usually consumed together. One does not buy the creaminess, the sweetness and the flavour of an ice cream separately, one buys ice cream.

Figure 2 shows an extreme example, chosen to be favourable to REM theory. Here two characteristics of a good are consumed together. The pleasure the consumer gets from more peppermint flavouring in the ice cream is independent of the amount of vanilla flavouring. The consumer buys a premixed product and can buy different goods (flavours of ice cream) but cannot change them once bought. In this example it is assumed that marginal utility first increases with the level of the characteristic, then becomes constant, then falls.

The result is that when there is increasing marginal utility, the indifference curve is concave to the origin, rather than convex as REM theory demands. People prefer to have all one characteristic or all the other. As quantities increase, a bull's eye appears, surrounding the optimum product mix. In order to get indifference curves like those of Figure 1, it is

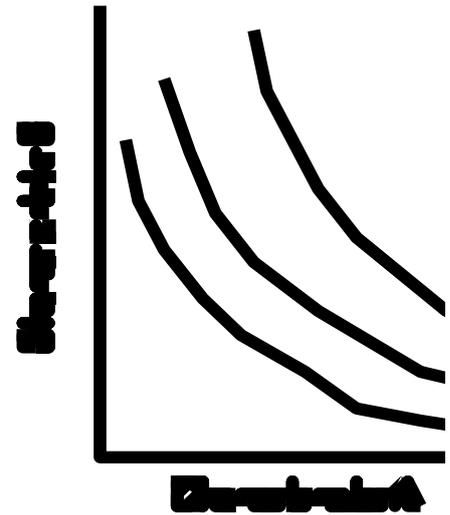


Figure 1



necessary to assume that there is a positive but declining marginal utility for all products at all levels and that this is true for all characteristics at all times. This is contrary to observed reality.

In practice, consumers seldom value quality characteristics independently. The preferred amount of peppermint in ice cream depends on the level of other flavours, on the cream and sugar content and so on. The utility obtained from one characteristic depends on the level of other characteristics, so ratio and proportion of characteristics are important. This can be seen in Figure 3 which shows a consumer's preferences for the characteristics 'sugar' and 'acid' in an orange. This consumer prefers an orange that is medium sweet, medium acid, so the highest indifference curve is at the centre of a bull's eye. If it is more acid, it will be perceived as sour, if less acid as bland, and either way it will be on a lower indifference curve. This is in stark contrast to the theories of Lancaster, Rosen and others in the REM research programme, which imply that consumers will always prefer the orange with the maximum amount of acid and sugar. It also raises the possibility of buying fewer oranges of a preferred characteristics mix, which these models do not allow. The fundamental assumptions of strict convexity, non-satiation, and all characteristics positively demanded clearly do not hold. In the previous example, it was shown that indifference curves like those in Figure 1 could be obtained when there was a positive but declining marginal utility, when the characteristics were valued independently. Here it has been shown that this is not usually so when the characteristics are valued together.

A wide range of indifference curves can be expected in practice (Bowbrick 1992). Figure 4, for example, shows the indifference curves for sugar and acid in apples. There is one utility peak for medium-acid, medium-sugar dessert apples and another one for high-acid, high-sugar cooking apples like Bramleys. The two peaks occur because there are two

end uses, but the claimed advantage of REM models based on objective characteristics is that they work regardless of end uses and consumer perceptions. Multiple-peak indifference surfaces are common and some are caused by the laws of physics, not by idiosyncratic consumer preferences. For example, a chord consisting of two notes as characteristics gives most utility when the notes are identical or an octave apart, and less utility at the discords in between. These multiple peak surfaces conflict with all the fundamental assumptions of REM theory.

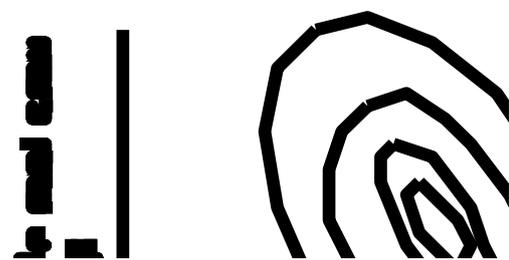
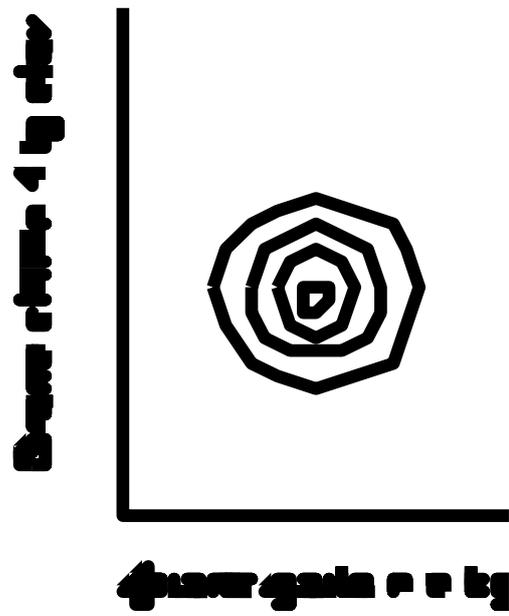
Figure 5 shows the common case where a pure product is preferred to a mixture and the indifference curve is concave.

All agricultural products may be contaminated. Milk is valuable when pure, but less so when contaminated by insecticides, manure, kerosene, etc. The contaminants themselves may be valuable when 'pure' and not mixed with milk. Obviously, anyone who buys a bottle of milk must consume the milk with the contaminants - it is not possible to extract the insecticides or kerosene at this stage.³ In Figure 6 the diagonal is the product possibility curve - milk plus contaminants equal 100%. If no contamination is acceptable, and pure milk and pure diesel are valued, the indifference curves consist of points where the axes meet the diagonal. Figure 7 shows the situation where some contamination is acceptable and indifference curves are points on the product possibility curve. Since contamination is a problem with all agricultural products, curves like this will occur between some axes of all products. There is no product for which the fundamental assumptions apply.

It is possible to change the shape of indifference curves by redefining the characteristics, talking of fructose instead of sugar and distinguishing between malic acid and citric acid in

³ The complexities of curves consisting of ingredient products where characteristics add up to 100% and other types of product, and the complexities of substituting quantity for quality are discussed elsewhere (Bowbrick, 1992, 1996). They are of tangential interest to the present discussion.

Figure 1



apples, for instance.

The fundamental assumptions of the REM theories of quality do not correspond with reality. They are not in any sense simplifications: they are false;

- * It is unlikely, but possible, that the indifference curves between two characteristics will be as in Figure 1 as REM theory demands. It is extraordinarily unlikely that this will be so for all characteristics of a good.
- * It is probable that many indifference curves between characteristics of a good will be of other shapes, like those shown here.
- * For all goods the threat of contamination means that some indifference curves will be very different to those assumed.

The fundamental assumption of REM theory is that all possible indifference curves of all individuals are of the shape shown in Figure 1. Without this assumption it is not possible to proceed to the initial paradigm cases.

Fundamental Errors on Characteristics Space

REM theories of quality consist of analysis in 'characteristics space' with axes of the form '[Level of] Characteristic A' and '[Level of] Characteristic B'. Conceptual and logical errors in the fundamental assumptions on characteristics space invalidate the theory.

There is not, in fact, one single characteristic space of this form. Figure 9 shows two sets of indifference curves plotted in a range of characteristics spaces and shows the very different shape of curves when the characteristics curves apply to the quantity in a stew, in a meal, in ice cream, in a standard sized meal and in ones diet (though one may wonder how many individuals have a concept of the level of chilli or garlic in their diet). Clearly any analysis that is valid for one of these characteristics spaces is invalid for any other. Lancaster uses up to fourteen such spaces interchangeably:

1. Total amount of characteristic in total consumption. This requires the assumptions of linearity and additivity. It appears to be the characteristics space used for the basic paradigm case.
2. Total amount of characteristic in the diet (1971, p17).
3. Total amount of characteristic in a single unit of a good. This is the space used for the automobile example (1971, pp.157-174).
4. One axis being 'Cleaning power per dollar' for goods in the product group detergent (1966, p.153). This conflates two characteristics and introduces concepts like value for money. It does not appear in Lancaster (1971).
5. Level of characteristic obtained from one or more goods in one product group. This appears to be the characteristics space used for most of the analysis, including that which at first sight uses the paradigm case (1971, pp.125-9).
6. Characteristics per unit of a good (1979, p28).
7. A space with a 'normalized' efficiency frontier, implying some kind of 'normalized' definition of characteristics (1971). This is used for his second paradigm case. In fact different 'normalized' spaces may be created starting from any of the six previous spaces and be related to total consumption, to an automobile etc. so there are many more than seven spaces used.⁴

It is not possible to proceed to Lancaster's second paradigm case of 'normalized characteristics'

without the boundary assumptions of linearity, additivity, perfect knowledge etc. which are discussed below.

⁴ Lancaster's 'normalized' curves are presented in a 'characteristics in total consumption' space, but most of his followers present the identical diagrams in a different space '[Normalized] level of characteristic [in total consumption] per dollar', without explanation.

Fundamental Assumptions on Supply

The supply assumptions of REM theory are also fundamental, as they are necessary for the first stage of the analysis, determining an individual's optimum purchase. The fundamental assumption is that the supply functions for all characteristics of every good are of the same form. It will be shown here that there are few products for which this is true of all or even most characteristics.

In traditional analysis based on separate goods it was reasonable to assume that all goods were positively priced and that one could get more of a good by paying more for it. REM quality theory carried this assumption over, assuming that characteristics were positively priced. One could only get a good with more of one characteristic by paying more (and the origin of the theory in agricultural economics stock feed mixing models is obvious here). These assumptions are no longer reasonable when dealing with a good whose characteristics are necessarily supplied together. Why should it cost any more to buy a good just because it has more of one characteristic? REM theory would require for instance that an orange with more acid content necessarily costs more. Figure 9, however, gives a more realistic picture. The constant outlay curves are highest around a medium-sweet, medium acid orange, as market demand is concentrated on these. The very acid and very sweet oranges are cheaper.⁵ This

bull's eye constant outlay curve is very different to the curve assumed by REM theory. The indifference curve of one individual, also a bull's eye, is shown next to this set of constant outlay curves. This individual's optimum choice is clearly made at a point where both constant outlay curve and indifference curves are concave to the origin and there will be a trade off between quantity and quality. This is contrary to the whole of REM theory which assumes that the acid in oranges is always positively required, and is always positively priced so that the most acid oranges are preferred and are the most expensive. It also has an optimum choice where the indifference curve is convex to the origin.

Most agricultural markets are price taking, and prices are determined by demand in the short run, so preferences like those in Figure 1-7 will lead to prices quite unlike those assumed by REM theory. Similarly, when input characteristics are different from the output characteristics, as in art, agriculture and most industry, there is no obvious reason why it should cost more to produce a good with a higher level of one characteristic. With many agricultural products those farmers with the skill to produce 'higher quality' from the same inputs earn an economic rent.

Price making markets seem more promising at first sight. If a good is made by mixing ingredients and those ingredients are characteristics (as with feedstuffs), then the assumptions appear to hold. However, it is not possible to operate such price-making markets under the REM assumptions that all buyers perceive the same characteristics in each good and are perfectly informed on price etc.

It is not possible to plot an individual's multidimensional indifference surface from observed purchases, especially in cases like Figure 8. This would require a very large number indeed of purchases in directly comparable situations - with all other factors, including prices of alternative goods, held constant. It is seldom that an individual makes even a dozen purchases that would meet this criterion.

Fundamental Assumptions on Subjective or Objective Quality

⁵ If there are economies of scale in production of one characteristics mix, the most demanded mix may be cheaper. Similarly low cost supermarket distribution may make popular characteristics mixes cheaper than less popular mixes marketed through delicatessens.

REM theories of quality are attractive because the analysis is based on objective characteristics, and ignore psychology, subjective preferences and so on. The approaches promise to be much cheaper and easier as a result. The fundamental assumptions of most such theories are (i) a good has objective characteristics, and consumers' decisions are made solely on these; (ii) all individuals see the same characteristics in each good and perceive them identically; (iii) individuals may value the characteristics differently. The REM theories explicitly ignore subjective attributes and may ignore characteristics which are difficult to measure.⁶

These assumptions are rejected by the whole of marketing and market economics and many branches of economics including information economics, the economics of advertising and the theory of monopolistic competition.

One approach used widely in marketing but inconsistent with the REM approach is that i) quality is in the mind of the consumer, and ii) consumers value a good purely for the characteristics they attribute to it subjectively. Choices are not made on the objective characteristics but on subjective attributes. The characteristics may or may not be related to the attributes, but advertising, brand image etc. means that the relationship is seldom simple. Even if the consumers can see some characteristics, they may or may not use them as a proxy for characteristics.

Hedonic theory is usually based on assumptions incompatible with REM theory. One formulation is 'I, the researcher, subjectively perceive that the goods on the market have certain attributes (that is to say I have no objective knowledge of which are characteristics as defined by REM theory and, accordingly, no way of measuring them). Regression shows that goods with more of attributes A, B and C get a higher price. I predict that if the marginal producer switches to producing a product with a higher level of A, B or C, then he or she will get a higher price.' This can produce accurate predictions when consumers use something akin to the researcher's attributes as cues or proxies for their own, possibly very different, attributes. It is not necessary that the researcher knows the characteristics as defined in REM theory, or that the consumer values them. Another common formulation is 'Market research shows that consumers ascribe certain levels of attribute to each good in this product group. Regression analysis shows that the goods with the highest level of attributes X, Y and Z fetch the highest price. It is predicted that if the marginal producer can increase the level of X, Y or Z, whether by changing production specifications or by changing the brand image, then he or she will get a higher price.'⁷ This formulation does not require any knowledge of objective characteristics by the researcher or anyone else.

If the assumption of objectivity is dropped, then REM theory falls away.

'If different individuals were to "see" the same goods in fundamentally different ways, there would be little point in devising an analysis to take account of the objective properties of goods. For then either it is meaningless to speak of "objective" properties, or those properties which are

⁶ 'The characteristics which appear in the analysis are assumed to be objectively quantifiable, as well as objectively identifiable, even though they are important characteristics (color for example) that do not fit this specification. Although color can be objectively *defined* by primary color composition and degree of saturation, color differences cannot be put on a simple scale like size or horsepower or vitamin C content so that everyone agreed that good A has twice as much per pound as good B.' (Lancaster 1979, p.18)

⁷ Consumer preference for an attribute, like 'refreshing' for an orange may be linear and positive even when the preference for objective characteristics like acids, sugars and juiciness is not. This makes hedonic theory more applicable for attributes than with REM theory.

objective are irrelevant to people's relationship to goods.' (Lancaster, 1971, p.6).

The REM approach can only work if it is possible to plot the indifference curves of all individuals on the same set of axes, and if each individual faces the same supply. This is not possible under any of the following conditions: individuals (i) perceive different characteristics in a good, (ii) perceive nonexistent characteristics like dietary fibre in beef, (iii) ignore 'objectively important' characteristics like dangerous food additives, (iv) perceive a different set of a good's characteristics as being relevant, (v) value the same set of characteristics but perceive and measure them in different ways - even with perfect knowledge of an automobile's power, for instance, individuals might perceive it in terms of engine capacity, top speed, acceleration from a standing start or ability to pull a trailer. In all these cases, neither the preferences of different individuals nor the supply facing them can be plotted on the same diagram.

A further set of constraints arises because subjectivity implies that people do not perceive characteristics correctly. In principle an individual could plot his or her own indifference curve, against attributes like 'My perception of attribute A' or even 'My perception of characteristic B'. If these diagrams are brought together onto another diagram with axes like 'Perceived level of Attribute A' or 'Perceived level of Characteristic B', the difference in perception means that a single good will occupy many different positions, perhaps as many as there are individuals. Similarly, price and budget lines will occupy different positions, depending on the 'quality' they are perceived to apply to.

If a researcher were to replot the diagrams against his or her own perceptions, so that the same point always applied to the same good, the shapes of the indifference curves would change. The smooth indifference curves presented here would become very jagged, showing that someone thought that two boxes of brand X were equivalent to one box of brand Y with identical ingredients, for instance. In this case, none of the REM assumptions of strict convexity, transitivity, completeness, continuity, non-satiation and all characteristics positively desired, can be expected to apply.

One of the biggest attractions of REM theory is that it claims to predict sales when the objective characteristics of a product are changed. In practice, attributes may change while characteristics remain constant because of advertising etc., or brand image may remain constant through repeated re-formulations of the product.

This analysis confirms Lancaster's belief that REM theory cannot work if subjectivity is allowed. It is not possible to reach even the basic paradigm case where the preferences and decisions of different individuals are compared on the same diagram. In practice even those

who work within REM theory find it very difficult to avoid using attributes, which suggests that the theory has no practical application.

BOUNDARY ASSUMPTIONS

Boundary assumptions set out the domain in which a theory is intended to work, and each of the REM theories has different boundaries. Surprisingly, these are seldom made explicit. The example of Lancaster (1966, 1971, 1979) is used here as he sets out his boundary assumptions and other assumptions rigorously and completely, as his formulation remains the paradigm case and as it is the dominant theory of quality today. Among the assumptions are:

- a) One unit of characteristic gives the same satisfaction whatever good it is part of. Chilli powder gives the same satisfaction in ice cream as in chilli con carne.
- b) It is the level of characteristic in total consumption that determines the satisfaction achieved: the level in any good is irrelevant. It does not matter whether the chilli powder is eaten neat, by the pound, or as a seasoning to many dishes.

None of his optimization or aggregation procedures apply where these assumptions do not hold. These assumptions are wrong if they are self-contradictory or if, as he admits is true of his 1975 paper, they rule out all reality. These assumptions limit the application of his theory to situations like the perfectly informed farmer mixing chicken rations, (ignoring most of the constraints) and this is the theory from which REM theory evolved. It cannot be used elsewhere. Hendler (1975), Ladd and Zober (1977) and Lucas (1975) strongly criticized this theory for its over restrictive boundary assumptions but, worryingly, only 1.5% of the people who have cited Lancaster in recent years have cited these criticisms.

AD HOC ASSUMPTIONS

Ad hoc assumptions are ones added to a theory because the theory will not work otherwise (Popper, 1972 pp15-16, 30, 1976 pp40, 42). They are not to be confused with fundamental assumptions, boundary assumptions or realistic assumptions made to fit a theory into a model of a real world situation. Typically each *ad hoc* assumption is an unrealistic assumption that limits the number of real life situations the theory can apply to. Each explicit *ad hoc* assumption introduces implicit assumptions. The more *ad hoc* assumptions there are, the less likely it is that the theory will apply to any real world situation. Lancaster is one of the few writers attempting to make his assumptions explicit. There are 40-60 explicit *ad hoc* assumptions in *Consumer Demand* with sixteen in Chapter 8 alone. Some are

- 'The Cobb Douglas functional form is assumed.' (Lancaster 1971 p73).
- 'Uniform distribution is assumed so that average income is constant ...' (Lancaster, 1971, p79).
- 'Goods are completely separable, sharing no characteristics' (Lancaster, 1971 p126).
- All other goods may be treated as identical, all being equally close or distant substitutes for this group. (Lancaster 1971, pp128-9).
- A characteristic may be treated as irrelevant if it does not appear in the preferences of a large proportion of the consumer population (Lancaster 1971, p146), which implies that we can ignore the fact that 20% of the population loves garlic.
- 'The most heroic assumption is the *uniformity assumption* on the nature and distribution of preferences ... In geometric terms it implies that the transformed indifference curves in specification-quantity space are all of identical shape and are tangent to the [Product Differentiation Curve] at the specification corresponding to the most preferred good' (Lancaster 1979, p47).
- When one is dealing with a group of closely related goods, all other goods may be treated as equally close substitutes for this group (Lancaster 1971 pp128-9). [He uses 'good' in the sense of a single product line].
- There is a uniform distribution of income so that average income is constant over preferences and there is a rectangular distribution of preferences, with constant density taken to be unity (Lancaster 1971, p79).
- The consumption technology is linear, after ignoring invariant characteristics, and a characteristic is irrelevant if there is a linear dependence in the technology (Lancaster 1971 p142). 'In many cases it will be appropriate to assume that characteristics technically related in this way are also related in the view of the consumer so that he reacts to any one of the related characteristics not to each of them separately.' (Lancaster 1971, p144).
- There are in addition many *ceteris paribus* assumptions. These are quite unexceptional if they are dropped at a later stage of the analysis. Since they are not, they are *ad hoc* assumptions in disguise.

It is not possible to determine whether or not the assumptions apply in any case, to determine an individual's transformed indifference curves in specification-quantity space for instance. Formally, they are no different from assumptions about how many angels can dance on the end of a pin. Surprisingly, Lancaster in *Variety, Welfare and Efficiency* (1979) draws from these assumptions a wide range of conclusions on 'welfare, variety and the GNP', 'intra industry trade between identical economies', 'variety in capital goods', 'the optimal division of labour', and 'variety and economic development'.

Two Stage Models

Lancaster's (1966) two-stage model was abandoned as unworkable in his later work. It had the infinitely more restrictive assumption that characteristics are derived from consumption activities in which goods, singly or in combination are the inputs. It can only work if, for instance, all consumers eating meals prepared from a shopping basket perceive the same output characteristics, regardless of which set of meals is prepared from it, or who cooks them.

HEDONIC PRICES

In the preceding sections reference has been made to hedonic analysis which goes back to Waugh (1928), which was market based, not REM based. This was established 35 years before most REM theory and is logically independent of it. Nevertheless Rosen (1974) is an attempt to justify Waugh from a REM standpoint and Lancaster is sometimes seen to have the same objective. Rosen's fundamental assumptions are close to Lancaster's, though the analysis develops in a different direction. The failings of REM theory discussed above mean that this support is invalid.

In addition, however, REM theory uses different prices from that used in hedonic theory.⁸ In REM theory the consumer makes a choice on the prices and characteristics of all goods on offer. This requires a price list valid at the time, not a regression: it is not necessary to know 'the price of a characteristic'. Regressions give little weight to those prices at which few transactions took place in the past and none to those at which no transactions took place. This means that most of the options open to a marginal consumer are missing from a hedonic price.

Figure 8 shows how easy it is to get totally misleading prices from linear hedonic regressions. If most transactions had taken place in the SW quadrant, the prices of both characteristics would appear to be positive, if in the NE both would appear to be negative. If most transactions were in the SE or NW, one characteristic would be positively priced, one negatively. There would be a poor fit if transactions were scattered randomly. Yet this is a situation where there is a clear, consistent and logical relationship between the price of goods and the level of their characteristics.

Why would a consumer with a price list wish to know the regressions or the 'price of each characteristic'? Market research suggests that people are more likely to rank goods by

⁸ 'Hedonic prices are defined as the implicit prices of attributes and are revealed to economic agents from observed prices of differentiated products and the specific amount of characteristics associated with them. Econometrically, implicit prices are estimated by the first-step regression analysis (product price regressed on characteristics) in the construction of hedonic price indexes'. (Rosen, 1974, p.34). The REM analysis is confusing: Rosen (1974) appears to assume that the set of prices facing buyers is *at the same time*:

- a market clearing price
- an average equilibrium price at the end of a day's trading
- the price facing each buyer and each seller at all periods through the day

their characteristics or attributes and then by their prices and after this make a choice. REM theories and hedonic theories deal with different types of prices so REM theory can neither support nor refute hedonic theory.

CAN PREDICTIONS BE TESTED?

It is not possible to test economic theories directly, as they are not presented in a way that applies to the real world. Instead they must be tested indirectly. Do models of real world situations and markets using Theory A predict better than models, otherwise identical, using Theory B? This test is possible if and only if there is no doubt that all the assumptions of the theory apply. If this were not so, inaccurate predictions could be taken as evidence that the assumptions did not hold in this case, rather than that it was bad theory. It is no criticism of a theory that it does not work outside its boundaries.

It has been shown above that there is a strong reason to believe that the assumptions do not hold in any real situation. It is further shown that it is not possible to determine in any market that most individuals have the preferences assumed (though it may be easy to show that they do not). Accordingly it is not possible to say in any case whether a prediction was wrong because the assumptions of the REM theory did not hold, or whether a good prediction occurred precisely because a bad theory was used in the wrong place.

Some of the epistemologies discussed below do not require realistic assumptions or correct logic: they require only that the predictions of a theory have been tested repeatedly and have been found to be consistently good predictors. This may be modified to the statement that they have been found to be good predictors in X% of cases, which requires that a much greater sample has been tested.

It would be extremely difficult and expensive to carry out such a programme of tests in the necessary systematic fashion. Several extensive literature searches have failed to show any evidence of such a programme for any one of the REM theories or their variants. Even if a programme had been attempted, it is doubtful whether meaningful results would have been obtained as there are well-recognized problems identified by the Victorians,⁹ Hutchinson (1938), Machlup (1963) and 'sophisticated falsificationists' (including Popper) in refuting a theory in this way.

Very few uses of the theory have been designed as tests: rather researchers have used the theory as a tool to make a prediction. The situations chosen have not been selected as random samples of a specific type of situation from a known population, and very few of the uses are reported - some gave 'negative' results and are unpublishable and others are commercial secrets. One cannot therefore, comb the literature and show that Theory X gives a better prediction in y% of cases.

The published literature is also misleading in another way: many of the papers do not use the theory they cite and much of what purports to be based on REM theory is in fact based on quite different theory, often attribute theory based on Waugh (1928). Lancaster complained of this (1971, pp113-4). Recent examples include: Larue, (1991); Williams, (1991); McDaniels, Kamlet and Fischer, (1992); Ortono and Scacciati, (1992); Thomas, (1993); Berliant and Raa (1991); Thomas (1993); Johnson and Fornell, (1987); Heffernan, (1990).

⁹ 'The ingenuity of these nineteenth century writers knew no bounds when it came to giving reasons for ignoring apparent refutations of an economic prediction, but no grounds, empirical or otherwise, were ever stated in terms of which one might reject a particular theory' Blaug (1980, p55).

HOW SERIOUS ARE THESE WEAKNESSES?

The following weaknesses have been identified:

Fundamental Assumptions

- A. The fundamental assumptions on preferences are wrong. They are contrary to observed fact. They are not simplifications of reality. It is improbable that any individual will have preferences like those assumed for any product group.
- B. Serious logical errors arise from confusions about characteristics space.
- C. The fundamental assumptions on supply are wrong in most cases. They may apply in price making markets but here other REM assumptions do not apply.
- D. The REM theories depend crucially on assumptions of objectivity. Most economists and market researchers think it essential to include subjectivity in any analysis.

Other Assumptions

- E. Boundary assumptions rule out most of the real world.
- F. The large number of *ad hoc* assumptions means that the theories do not apply to any real world situation.

Do the assumptions apply?

- G It is not possible to say in any situation that the fundamental, boundary or *ad hoc* assumptions apply, though it may be possible to say they do not. It is not possible to plot a multi dimensional indifference surface for an individual, or in practice the prices facing an individual. Accordingly, bad predictions may arise because the theory is operating outside its domain, not because it is a bad theory.

Has the Theory been tested?

- H There has been no programme of crucial tests on any of the REM theories or their variants.

ARE THESE WEAKNESSES FATAL?

REM theory fails in its own terms: all REM theory is constructed in the belief that there is a special virtue in applying strict logic to stated assumptions.

Agricultural economists usually believe that there is a virtue in working from what we know - observed facts about agricultural markets - to what we do not know - predictions. Many can expect to lose their jobs if they make patently false assumptions, that beef grows on trees, for instance, however accurate the predictions of the resulting model. From this epistemological viewpoint the REM theories must be rejected because they conflict with observed reality.

The idiosyncratic belief that theories can only be tested by their predictions, and that assumptions are irrelevant, is strange in a discipline where it is easy to test assumptions and very difficult to test predictions. Even under this epistemology, the lack of testing means that we have no reason to prefer these theories to any of an infinite number of possible alternatives. Even under Friedman's (1953) approach, accepted by some economists, the fact that assumptions are contrary to observed reality makes these the least attractive of the untested theories.

REFERENCES

- Becker, G.S.** 'A theory of the allocation of time'. *Economic Journal* 75:493-517, 1965.
- Berliant, M., and T. T. Raa**, 'On the continuum approach of spatial and some local public goods or product differentiation models: some problems' *Journal of Economic Theory* 55(1) pp95-120, 1991.
- Blaug, M.**, *The methodology of economics: or how economists explain*, CUP, Cambridge, 1980.
- Bowbrick, P.**, *The Economics of Quality, Grades and Brands*, Routledge, London 1992.
- Brems, H.**, 'Input-output co-efficients as measures of product quality', *American Economic Review*, 47, 105-18, 1957.
- Brems, H.**, 'The interdependence of quality variations, selling effort and price', *Quarterly Journal of Economics*, 62, 418-40, 1948.
- Earl, P.**, *Lifestyle Economics: Consumer Behaviour in a Turbulent World*, Brighton, Wheatsheaf, 1986.
- Friedman, M.**, *Essays in Positive Economics*, Chicago, University of Chicago Press, 1953.
- Gorman, W.M.**, 'The demand for related goods', Journal paper J3129, Iowa Agricultural Experiment Station, Nov. 1956 (reprinted as Gorman 1976, 1978)
- Heffernan, S.A.**, 'A characteristics definition of financial markets' *Journal of Banking and Finance*. 14 583-609, 1990.
- Hendler, R.**, 'Lancaster's new approach to consumer demand and its limitations', *American Economic Review*. 65 194-200. 1975.
- Houthakker, H.S.**, 'Compensated changes in qualities and quantities consumed', *Review of Economic Studies*. 3 [19] 155-154. 1952.
- Huber, G.P.**, 'Multiattribute utility models: a review of field and field-like studies', *Management Science*, 20, 1393-1402, 1974
- Hutchison, T.W.**, *The significance and basic postulates of economic theory*, 1938
- Ironmonger, D.S.**, *New commodities and consumer behaviour*, Cambridge, Mass. University Press, 1972.
- Johnson, M.D., and C. Fornell**, 'The nature and methodological implications of the cognitive representation of products', *Journal of Consumer Research*. 14, 214-227, 1987.
- Knight, F.**, 'What is "truth" in economics?' *Journal of Political Economy*. 1940
- Knight, F.**, 'The significance and basic postulates of economic theory. A rejoinder' *Journal of Political Economy*, 49, 750-3.
- Ladd, G.W. and M. Zober**, 'Model of consumer reaction to product characteristics', *Journal of Consumer Research*. 4 89-101. 1977.
- Lancaster, K.J.**, 'A new approach to consumer theory', *Journal of Political Economy*. 74 132-157. 1966.
- Lancaster, K.**, *Variety, equity and efficiency*. Columbia studies in Economics no 10. New York and Guildford. Columbia University Press. 1979.
- Lancaster, K.J.**, 'Socially optimal product differentiation', *American Economic Review*. [September] 99-122. 1975.
- Lancaster, K.J.**, *Consumer demand: a new approach*. Columbia University Press, New York. 1971.
- Larue, B.**, 'Is wheat a homogeneous product?' *Canadian Journal of Agricultural Economics*. 39 103-7, 1991.
- Leland, H.E.**, 'Quality choice and competition', *American Economic Review*, 67, 127-137, 1977.
- Lucas, R.E.B.**, 'Hedonic price functions', *Economic Inquiry*, 13 157-78, 1975.

- McDaniels, T.L., M.S.Kamlet and G.W.Fischer**, 'Risk perception and the value of safety', *Risk Analysis* 12 (4) 495-503, 1992.
- Machlup, F.**, *Essays on economic semantics*, Englewood Cliffs, Prentice Hall, 1963.
- Mieses, L. von**, *Human action. A treatise on economics*, London, William Hodge. 1949.
- Muth**, 'Household production and consumer demand functions', *Econometrica*, 34:699-708, 1966.
- Ortono, G., and F. Scacciati**, 'New experiments on the endowment effect', *Journal of Economic Psychology*, 13 277-296, 1992.
- Popper, K.R.**, *Unended Quest: an intellectual autobiography*, Fontana/Collins, 1976.
- Popper, K.R.**, *The Logic of Scientific Discovery*, Hutchinson, London, 1959, Eighth impression 1975.
- Popper, K.R.**, *Objective Knowledge, an evolutionary approach*, Oxford, Clarendon Press, 1972.
- Ratchford, B.T.**, 'Operationalizing economic models of demand for product characteristics', *Journal of Consumer Research*. 6 [1] 76-84. 1979.
- Rosen, S.**, 'Hedonic prices and implicit markets: product differentiation in pure competition', *Journal of Political Economy*. 82 34-5. 1974.
- Stigler, G.J.**, 'An analysis of the diet problem' *Journal of Farm Economics*, May 1945.
- Thiel, H.**, 'Qualities, prices and budget enquiries', *Review of Economic Studies*, 19, 129-47, 1952.
- Thomas, J.M.**, 'The implicit market for quality: an hedonic analysis', *Southern Economic Journal*, 59 (4) 648-674, 1993.
- Waugh, F.V.**, 'Quality change influencing vegetable prices', *Journal of Farm Economics*, 10, 185-96, 1928.
- Williams, A.W.**, 'A guide to valuing transport externalities by hedonic means', *Transport Reviews*, 11(4) 311-324, 1991.