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# Exemplary Goods: The Product as Economic Variable

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Abstract: This paper offers an alternative to existing economic theories of goods, which conceptualize goods as bundles of objective characteristics. We present two cases of Starbucks and *Disraeli* (1929 film) to show that relevant qualities of goods – along with costs and prices – emerge from the process of economic competition. The properties or characteristics of goods should thus not be taken as given. We extend the idea that economic competition is a discovery procedure beyond the discovery of costs and prices to discovery of qualities offering another way of thinking about quality adjustments through the novel theoretical concept of exemplary goods. Exemplary goods, as we argue, have a coordinative role on markets that is complementary to the role of prices. The paper concludes with implications about the delineation of goods, and the emergence of markets challenging some of the current normative conclusions in the literature.

*JEL classification:* D4, L15, Z1

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# Exemplary Goods: The Product as Economic Variable

## Introduction

Prices have long been accepted as the outcome of the subjective valuation of individuals. But the way in which goods are conceptualized in economics is still rooted in an older objective or essentialist view. Ever since Kelvin Lancaster conceptualized goods as combinations of objective characteristics, the economic theory of goods has not progressed much (Lancaster 1966; Lancaster 1971). In a recent paper on consumption, Pedro Bordalo, Nicola Gennaioli and Andrei Shleifer (2013), argue that goods can be analyzed as consisting of a quality independent component, and a quality-dependent component. The quality dependent component of the good, say, coffee, is what is essential to it being coffee. In their model, producers can then decide to add some characteristic to the basic product, in this case quality. One of the few examples in Lancaster's classic work on the consumption of goods is the addition of hand lotion to washing detergent. The basic idea has remained the same: goods can be neatly divided up into a few basic characteristics. This is also the basic idea underneath the calculation of shadow prices of individual characteristics of goods (Rosen 1974; Epple 1987; Pakes 2003).

One might think that this remnant of essentialism in economic theory is of relatively little consequence: the conceptualization of goods has never been a research priority in mainstream economics. But a growing number of markets, such as those for consulting services, movies, or dining experiences consists of goods which are all unique (Caves 2000; Karpik 2010). In such markets, which often rely on fine-grained distinctions between genres, origin or type of service, classification can make a lot of difference. More importantly, new innovative goods, services and experiences frequently upset traditional barriers between goods, and thus between traditional

categorizations of markets. Thirdly the creation of markets which were long monopolized by the government such as energy supply, or which have only recently been recognized as economic goods, such as the famous frequencies in the FCC auctions or pollution rights, or goods for which market mechanisms have only recently been adopted such as organs (Becker and Elías 2007; Kuchař 2015) rely on particular conceptualizations of the good. It is of crucial importance to understand what is actually being traded, for these markets to function.

A better conceptualization of goods, and the way they are perceived as similar or different by market participants is thus of great importance. Bordalo, Gennaioli and Shleifer (2013; 2016), building on Lancaster's work, wrongly presume that goods are naturally part of some distinct market such as the market for automobiles, or the market for coffee. An implicit consequence of this line of thinking is that we can isolate this particular market when we conduct our analysis. The problem of comparing goods is consequently only half-illuminated. We get a clear sense of how goods within a particular market are compared to one another, but not why these goods are considered to be part of the same (sub)-market in the first place. A more complete theory of consumer choice should be equally attentive to what makes products similar, in the eyes of consumers. Although our alternative will introduce a more subjectivist notion of the goods, we do not wish to argue that the distinctions between goods are purely subjective for the individual, instead we contend that they are the outcome of a coordination process between producers, consumers and intermediaries, much like prices are the outcome of a coordination process between many individuals.

This paper offers a way of thinking about quality adjustments through the novel theoretical concept of exemplary goods. Our argument is that just as consumers and producers compare relative prices, they compare relative qualities. Economists no longer believe that goods

have some natural value or objective price, instead, goods are thought to be priced in relation to other goods. We attach significance to relative prices. Yet for some reason, the majority of economic studies still presume that goods have objective characteristics independent of consumers' judgment. We believe that thinking about (certain) existing goods as exemplars will shed important light upon the process of quality adjustment and, ultimately, on the emergent nature of classification schemes.<sup>1</sup> Exemplary goods, we will argue, have a coordinative role on markets, in the same way that prices do.

The first section will contrast the non-essentialist theory of exemplary goods with the essentialist theories of Lancaster and Bordalo, Gennaioli and Shleifer. Section two presents two case-studies of the introduction of new exemplary goods to illustrate how the theory of exemplary goods sheds light on the competitive process, and more specifically, on how new goods come to be understood as (dis)similar. Section three generalizes our case-studies to a theory of market competition which incorporates competition on quality and exemplary goods. While we recognize that competition is a discovery process, it is not merely a discovery of costs and prices, but also of relevant qualities and the relations between goods. Finally, we show that the qualities and their meanings are mutually coordinated and discovered in the interaction between consumers, and producers and intermediaries.

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<sup>1</sup> The exemplary theory of judgment relies on knowledge available in markets, and is therefore a type of ecological rationality (V. L. Smith 2008; Gigerenzer 2008).

## 1. Essential and exemplary characteristics

The great step forward in Lancaster's theory of goods is to argue that goods are not single entities, but are instead bundles of more fundamental characteristics. Lancaster makes this point because he is aware that without such a theory, there is no way in which economists have something to say about the relationships between goods: whether they are substitutes or complements. Such judgments can only be a kind of common-sense knowledge, but cannot follow from the theory. So he proposes to think of goods as bundles of characteristics, which overlap between different goods.<sup>2</sup> Goods which overlap significantly in their fundamental characteristics will be substitutes.

Any good possesses an enormous number of physical properties: size, shape, color, smell, chemical composition, ability to perform any one of a variety of functions, and so on. Because not all properties will be relevant to choice, we shall henceforth use the term *characteristics* for those objective properties of things that are relevant to choice by people." (Lancaster 1971, 6)

Lancaster's fundamental insight that goods are bundles of characteristics is a great step forward in consumer theory. It leads directly to the theory of bundling and unbundling which deals with the issue of why certain characteristics would typically be sold together, while others would be

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<sup>2</sup> Even at the time that Lancaster proposed his theory of goods there were important criticisms available of an objectivist theory of goods. Edward Chamberlin recognized clearly that the variety of goods and the circumstances in which they are sold are infinite, thus making a delineation of some partial market highly arbitrary (Chamberlin 1953, 9). The idea that the objective characteristics of the product could be isolated from the related services, information, and circumstances in which the products was sold was further criticized in the industrial organization literature, which at time was concerned with the 'value' provided or 'waste' generated by advertising (Goldschmid, Mann, and Weston 1974, chapter 3). For those authors it was clear that goods were not priced bundles of objective characteristics, but rather that entrepreneurs were engaged in a process of constant adjustment on multiple margins including price, quality, scope (bundling and unbundling of goods), advertising and whatever else might have been part of the product. The product, in this perspective, is itself an important economic variable (Chamberlin 1953; Kirzner 1973, 135–146).

sold separately, i.e., it highlights that one part of the competitive process is figuring out the relevant bundle of characteristics.<sup>3</sup> But, Lancaster leaves us in the dark as to how do we determine *which* characteristics are bundled in a particular good and how this bundling of characteristics happened. What Lancaster has done is only to move the problem one level up (or down, depending on the perspective of the reader). It is doubtful whether we should be any more satisfied with the common-knowledge judgments of economists about the relations between goods, than we should be about similar judgments regarding the characteristics which are relevant to choice.

In a recent body of work, Bordalo, Gennaioli and Shleifer (2013; 2016, henceforth we refer to the authors as “BGS”) focus on price and quality as two alternative ‘salient’ attributes which determine consumer choice. There is a direct link to Lancaster’s theory of goods, the entire argument of BGS including the policy conclusions they draw from it, is dependent on our ability to identify the product characteristics relevant for consumer choice. During periods when ‘quality’ is salient, firms will have to compete on the basis of quality, because consumers will overweight this attribute in their decision (BGS 2016, 482). During periods in which ‘price’ is salient, we will see price competition dominate. BGS argue that markets can end up in inefficient equilibria, for example a low-price equilibrium in which no attention is paid to improvements in quality. Lancaster and BGS emphasize that the quality of the good is chosen by the producer and known (or at least stochastically known) by the consumer. The fact that quality is chosen, based on the costs of producing additional quality, in effect means that market outcomes are an

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<sup>3</sup> In that sense there is a direct but little acknowledged line between current discussions of bundling and unbundling and Lancaster’s theory (James and Yellen 1976).

outcome of purely technological changes which impact the cost structure of a particular industry.<sup>4</sup>

There is a more fundamental problem with the way in which Lancaster and BGS think of goods. By fixing the characteristics which make up a product, or at least those which are relevant to consumer choice, they create an essentialist notion of what the good in question is. The consequence of this is that they create a kind of natural map of markets: the market for fast food, the market for budget air travel, the market for financial services and the market for fashion (to name two which BGS associate with the ‘price’ salience and two which they associate with the ‘quality’ salience). Not only do they neglect the way in which these market became coherent markets in the first place, they also fix what the product being traded in these market is. Consequently, when BGS (2016) analyze the entrance of Starbucks into the coffee market, they have to interpret this as an instance of Starbucks competing with (cheap) home-brew coffee, rather than as a quite fundamental change in the good, or the introduction of a good which upsets current categorizations. We contend that any convincing account of the introduction of Starbucks will have to take into account that the company contributed to a radical transformation of characteristics that were relevant to consumer choice, that is, the company managed to induce the alteration of the way in which the product was understood and categorized by consumers.

To develop an alternative to this essentialist theory of goods, we propose a theory of exemplary goods. What exemplars are and how they are used by individuals to make judgments, is developed in Hannah Arendt’s theory of exemplary validity. Her theory of exemplary

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<sup>4</sup> This line of reasoning merely falls back into an old fallacy, which in the 1970’s surrounded the failed attempts by critics of advertising to distinguish between production costs and selling costs. A distinction rightly criticized by Harold Demsetz (1964; 1968), Yale Brozen (1974) and Israel Kirzner (1973, chap. 4)



reasoning is explicitly developed as a critique of essentialist notions of categories. Consider a table, she argues, we could have in mind an essential list of characteristics to which every table must conform to qualify as a table, if we then meet an object we can determine whether it fits the requirements. Does it have a flat top surface? Does it stand on legs? Does it have the correct height, etc.? Economists following Lancaster tend to use this kind of laundry-list approach when they think of markets for goods as well-defined entities. The exemplary mode of reasoning on the other hand: “thinks of some table as the example of how tables actually should be: the exemplary table. This exemplar is and remains a particular that in its very particularity reveals the generality that otherwise could not be defined” (Arendt 1982, 72). In this exemplary sense we use the particular to illustrate the general, in Arendt’s words, we say for example that to be courageous is to be like Achilles.

Arendt argues that thinking in terms of exemplars is “the faculty of thinking the particular” (Arendt 1982, 76). Pure thinking for Arendt is thinking in the general, it is thinking in rules, laws, regularities, and categories.<sup>5</sup> To judge, on the other hand, is to consider the particular in light of some category, while keeping in mind the uniqueness of the particular. Occasionally we will find particular instances which we cannot yet relate to some existing category, and then we have to consider the particular in light of other particulars. When a new good is thus introduced on the market it is judged in relation to known exemplars, rather than fitted in a particular category<sup>6</sup>. Home-brewed coffee, or a particular brand of it, is one exemplar that will be relevant, but so will other neighboring exemplars as we will demonstrate below.

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<sup>5</sup> See also Hayek ([1968] 1978) on the primacy of the abstract.

<sup>6</sup> A good is not exemplary unless it manages to coordinate expectations about how one is supposed to act with regard to the good in question. This coordination of expectations takes place through contestation; exemplars

Theorists of exemplars emphasize the *gradedness* of categories (Mervis and Rosch 1981; Barsalou 1985).<sup>7</sup> Gradedness of categories means that not every member is an equally good example of a particular category. ‘Robins’, for example, are consistently considered to be exemplary birds, but penguins far less so (they seem to be closer to some exemplary fish). Such exemplars are learned faster by children, and play a crucial role in category formation (Lynch, Coley, and Medin 2000). One might think that exemplars represent a central tendency in the category: a bird has wings, feathers, and a beak, it is relatively small and it flies, features which the robin matches better than the penguin. But more recent studies have distinguished between a typical (central) instance and an exemplary instance. These sometimes overlap, but particularly when a notion of goodness is involved, as is the case for market goods, the exemplary tends to be close to some ideal, and thus far from the typical or central (Barsalou 1985; Lynch, Coley, and Medin 2000; Burnett et al. 2005).<sup>8</sup>

Exemplary goods are goods (or services) that are successful and therefore are imitated by competitors.<sup>9</sup> The iPhone has been an exemplary smartphone for a while, in the same way that

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emerge as solutions to social conflicts. In this sense, the meaning of exemplars is (at least potentially) always contested. Furthermore, exemplars can be seen as ontologically autonomous social media or focal public representations that “induce” certain beliefs and expectations, they are signs that induce dispositions to see the world and act on it in a particular way (cf. Aoki 2011; Hermann-Pillath 2016).

<sup>7</sup> Some of the early authors on exemplars noted the connection with family resemblances as described by Wittgenstein (Rosch and Mervis, 1975).

<sup>8</sup> BGS instead rely on a simple average of the characteristics for their definition of the reference good: “the choice context is summarized by a reference good (...) where the reference or normal levels of quality and price are their average values” (BGS 2013, 820). In a paper critical of the characteristics definition of goods Steven Payson (1995) develops the notion of the ‘representative good’, but he relies on the median product in the market.

<sup>9</sup> An exemplar is, as an old definition has it: “a pattern; an example to be imitated” (Needham 1985).

say Harvard and Cambridge are exemplary universities. These goods, or sometimes brands, teach us about something about the characteristics and qualities of a category of goods, even when we cannot always fully describe or articulate what that quality consists of. Exemplary goods and practices contain tacit knowledge about the dos and don'ts that is often hard to codify (Polanyi 1958). What a modern university is and whether it is different from a college, a think-tank or a 19th century university, has been discovered through the course of time. Neither the relevant characteristics, nor the way in which universities are compared, nor the relationship of this particular category of goods to other categories has remained unchanged. Initial smartphones were closer to traditional mobile phones, but more recent versions have moved closer to tablet, computers and sometimes even TV sets.

Just like the prices and costs cannot be treated as fixed in the process of economic competition, so specific markets, and categories of goods cannot be treated as fixed for any more than short periods of time. As Chamberlin argues: "Products are not in fact 'given', they are continuously changed – improved, deteriorated, or just made different – as an essential part of the market process" (Chamberlin 1953, 3). And since the offered product constantly shifts, the relationships between products, their cross-price elasticities if you wish, also changes.<sup>10</sup> A theory of exemplary goods allows us to leave behind essentialist notions of what a table, a coffee, or a university is, and to treat the relevant characteristics of these goods as something which is discovered in the process of competition (Hayek [1968] 2002). Exemplary goods make us recognize that categories are formed around particular, exemplary instances. This is the case, for

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<sup>10</sup> One important consequence of the constant change in products is that "The conception of the economic system as divisible into distinct markets for separate commodities is after all very largely the product of the imagination of the economist" (Hayek 1948, 98).

example, for categories named after their exemplary instance: baby's onesies, jeans, the jacuzzi, and the jeep. Secondly, exemplars emphasize that although some instances might be a perfect fit in a category, others are border-line cases, which do not fit current categories well (Zuckerman 1999; Kennedy, Lo, and Lounsbury 2010). Thirdly, exemplars are able to capture the market dynamic in which particular products are placed within a category, but are also represented as standing out from that category. This use of the exemplary is particularly visible in advertisements in which the uniqueness of the particular product is emphasized against the shared qualities of other products ("this is not just food, but M&S food" as one slogan has it).

## **2. Starbucks, Disraeli and the source of commercial success**

We present two illustrative case studies here to analyze the role of exemplary goods as focal points in market competition, and their role in the formation of categories. The first is an alternative interpretation of the Starbucks story as presented by BGS (2016), and the second one discusses the emergence of the biopic genre in film, and draws on the work of Rick Altman (1999).

### **a. Starbucks**

To illustrate their theory of salient characteristics BGS use the case of Starbucks coffee. The argument goes that Starbucks was successful in making quality, rather than price salient, and consequently the industry shifted from cost-reductions to offering superior quality. The case-study is illustrative of the idea that there are distinct markets in the economy in which competition takes place. When Starbucks opened up its café-style shops 1987 to sell high-quality espresso-drinks to a mass market they were quickly successful and by 2000 Starbucks had expanded to 3,500 stores, and to over 11,000 in 2010. The authors argue that Starbucks was

competing in the market for coffee, with home-brewed coffee and other restaurants which offered coffee. It would be silly to deny this, but by focusing on the product of coffee alone we fail to understand what Starbucks managed to achieve. According to BGS, Starbucks merely found “a profitable way to sell espresso drinks for the mass market, by providing consistently high quality delivered by trained baristas” (BGS 2016, 500).

But even BGS have to observe that Starbucks also changed the atmosphere in which coffee was consumed, that it offered a wider range of coffees, to which we could add that they sell a range of complimentary snacks and cakes, that they provide Wi-Fi and comfortable chairs, that they used alternative marketing techniques, that they personalized service, that they greatly expanded the range of drinks on offer, even for those who do not particularly like coffee, etc. In terms of exemplars, they managed to introduce a new good, that can still be compared to (and hence compete with) home-brewed coffee, but which also could now be related to the pastries offered in bakeries, and to the social function of cafes, restaurants and even libraries. In fact, Starbucks started the trend to serve as an alternative office space for self-employed workers and writers (Woldoff et al. 2013). BGS (2016, 501) speak of a ‘Starbucks effect’ that they observe on the quality of coffee beans offered in the supermarket, but a similar effect (in different incarnations) might have taken place in bakeries, in cafes and restaurants, as well as in libraries and in the office world, and we of course know it has.

So when BGS claim that the ‘Starbucks effect’ “results from Starbucks’ introduction of a different technology that allowed it to offer much higher and salient quality,” this grossly misrepresents what has happened in the market. Their claim does not specify *what* is of much higher quality (the chairs perhaps?) as what Starbucks did is not similar to a change in harvesting techniques which would lower the costs of high quality beans. But it was precisely the ‘what’,

the product, that changed through their innovation. The product and the way it was understood by consumers, and hence how it was valued was the key aspect that changed. BGS provide some evidence that the total quantity of coffee remains unchanged to make the argument that Starbucks managed to replace the yesteryear's low-quality coffee. But the constant quantity now bought at a much higher price if clear evidence of anything, is that consumer valuation of the good in question changed. Even that, if our story is correct, would not be completely accurate, however. There is no market for coffee with fixed boundaries. Starbucks introduced a good that would soon become exemplary, a new focal point to which other producers soon gravitated altering the boundaries between markets.

The consequence of this alternative interpretation is that the normative conclusions that BGS draw from this story and their general theory no longer hold. They argue that the introduction of 'Starbucks' was "causing a reduction in the price sensitivity of *all* consumers" (BGS 2016, 501). With the implication that consumers had been wrong before, they focused too much on price. In our alternative interpretation of exemplary goods, to the contrary, a new good is introduced which opens up new opportunities not just for producers, but also for consumers who adjust their behavior accordingly. That is, we do not have to posit a sudden shift in the price sensitivity of all 'coffee' consumers. Instead, the theory of exemplary goods allow us to recognize that new goods, and relevant characteristics, or qualities, are discovered in the market process. The price-focused consumers in the pre-Starbucks world were only wrong if Starbucks were merely a new combination of existing characteristics. Then we can say that they were too focused on the salient quality of price.<sup>11</sup> But if we instead recognize that new relevant characteristics (or

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<sup>11</sup> An additional problem with the theory is that a switch back to price being the salient characteristic is hard to imagine, unless we now start to think of 'Starbucks'-type coffee as the basic product around which fierce price-

qualities) and new products are discovered in the competitive process, then consumers were in fact learning about new alternatives. In such an open-ended world saying that price-focused coffee consumers were wrong before, is like saying that consumers were too focused on the prices of hand-held calculators before the PC was introduced.

### **b. *Disraeli (1929)* and the birth of biopic**

This second illustrative case further explains what the implications of an open-ended discovery process of the market are. It demonstrates how qualities are discovered in the interaction between consumers, producers and intermediaries. In this process, exemplary goods are crucial. This case-study is based on Rick Altman's book *Film/Genre* (1999) and particularly on his story of the emergence of the biopic, a movie genre in which the life of a historical figure is narrated.

In the movie industry, the producer's job is forward looking in nature. The producer can identify successful films, but he does not know with any certainty what has made these films successful. Instead he engages in a process of trial and error based on past successes. The critic's job, on the other hand, is backward looking in nature: she evaluates films in hindsight. So if the critic wants to write the history of a genre such as the Spaghetti Western, she can assess all the films that are said to belong to that genre, from which she can form a general description of the genre. As such the critic, argues Altman, is with the benefit of hindsight able to use an

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competition takes place. In the BGS story this would be a highly artificial move, but in the theory of exemplary goods, it is natural to expect that after a new exemplary good has established itself on the market, that competitors will offer similar products and compete on price or any other relevant margin. In that sense, our theory is in line with the way that Schumpeter talked about the temporary monopoly that the innovative firm could establish (Schumpeter 1961).

essentialist notion of a genre. But the producer (nor the consumer for that matter) does not have this knowledge, and is instead finding his way through with help of the currently existing exemplary goods.

When Warner Bros. produced the film *Disraeli*, about the British politician and author, they thought they were ‘simply’ adapting a successful musical and earlier silent film into a new film. And indeed, the film, released in 1929, starring George Arliss (who had also played the lead role in the silent film and the musical) went on to become a great worldwide commercial success. It attracted around 170 million viewers in 29,000 theaters over the following years. Warner Bros. and other film studios were therefore eager to go on imitating its success. But this posed the problem of figuring out what had made the film so successful in the first place:

What does the film have that might be worth imitating? In 1929, Warner Bros. saw *Disraeli* not as a biopic – a non-existent category at the time – but as a film whose success was due to its primary emphasis on British history, political intrigue and international strife, with secondary attention to financial concerns, Jewishness and expansive speech-making, plus perhaps a nod to director Alfred E. Green and the film’s stage-play source. (Altman 1999, 40)

Shortly after the success of *Disraeli*, Warner Bros. produced three other ‘British’ films, *The Green Goddess* (1930, starring Arliss), the more comedic *The Man from Blankley’s* (1930), and *Sweet Kitty Bellairs* (1930, directed by Green). All three films were based on earlier stage plays or musicals, but the success of *Disraeli* was unmatched. Warner Bros. then attempted to drop the musical and romantic aspects in favor of more financial and Victorian subject matter in *Old English* (1930, with Arliss and directed by Green). Unlike the preceding three flops, this film turned out to be a success soon to be followed up by another financial adventure, called *The Millionaire* (1931, starring Arliss). Soon after came *Alexander Hamilton* (starring Arliss), a film



without the British flavor, but with the political intrigue and the biographic treatment of one character.

*Alexander Hamilton* turned out to be a great success. As Altman makes clear, in retrospect it is easy to see the similarities between *Disraeli* to *Alexander Hamilton*, and recognize them as early examples of the biopic. But that is only when we have the benefit of hindsight, the perspective of the critic, and a clear notion of what the genre is, which allows us to recognize them as similar. The forward looking producer instead is engaged in a trial-and-error in which various characteristics and qualities are combined, and in which the end point is uncertain. As the iterations in this case made clear, *Disraeli* could have started a genre of Victorian films, or of financial adventure films, but those genres never materialized. Instead *Disraeli* came to be considered the first biopic.

During the trial-and-error process in which the producer was engaged this was not at all clear. *Alexander Hamilton* was not marketed at all by Warner Bros. as a kind of sequel to *Disraeli*. Instead it was presented as an American historical movie, one that notably included a scandalous affair. And that was indeed how Warner Bros. followed up the success of *Alexander Hamilton*. So as Altman concludes: “not even the simplest description of a film holds up throughout the game, because each new film undermines our previous understanding” (Altman 1999, 41). The relevant characteristics for consumer choice were not known to the producers, they only became apparent in the competitive market process.

In this competitive market process exemplary goods are important, they are the goods which are imitated by producers. But only after various iterations does it become clear what combination of characteristics are valued by consumers, and how they fit together, or in other words how they form a genre or a market category. *Disraeli* as a film has an enormous amount

of interdependent characteristics, so the question remains: What are the qualities that should be imitated and in what combinations? As Altman argues: “the [biopic] genre was not created until multiple studios, repeatedly replicated *specific* biographical elements of earlier films” (Altman 1999, 43). In the film market, like in many other markets, intermediaries are an important factor in making sense of these new products, in linking them together.<sup>12</sup> This process of emergence is central in the further development of the theory of exemplary goods.

### **3. The discovery of focal qualities through exemplary goods**

The competitive process of markets is widely believed to be a good way of finding the most efficient way of minimizing costs, and of discovering the price which clears the market. But as we can see in the case of Starbucks and *Disraeli*, this is not the whole story. Competition is not just a price-quantity discovering procedure, it is also a process through which the relevant characteristics and their combinations are discovered. The two illustrative cases demonstrate that the relevant characteristics of the good were not fixed throughout the process of market competition, rather, they were discovered. In the process of competition, the categorization of the product changed, as is clearest in the film example. Although the producer marketed *Disraeli* as a new version of an earlier silent film and musical, in the end the movie came to be understood as an early and exemplary instance of a biopic. In the Starbucks case, too, we have argued that the change is better understood as an introduction of a new type of good, whose relation to existing products was not instantly clear. One way of interpreting and marketing the good is as higher quality coffee, the BGS (2016) interpretation. But it could equally be interpreted as an

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<sup>12</sup> In film reviews for example, comparisons are frequently drawn between particular exemplary films. This is the most tastefully, subtly designed Japanese film since the memorable “Gate of Hell” (Dekker 2017).

instance of more variety, better service or superior ambiance. The former interpretation would mean that the product category of coffee remains more or less the same, the latter interpretation means that the product had been fundamentally changed in the evolutionary process of competition.

Existing economic theories which rely on an essentialist notion of goods are unable to capture this product evolution (Payson 1995). They have to argue that all of these goods are part of some fixed product category. Our theory of exemplary goods, on the other hand, emphasizes that the relevant characteristics and, above all, the relationship of these characteristics to other goods are discovered in the competitive process. What occurs is a trial-and-error process of newly introduced goods that typically fail to catch on. Only every now and then a new good succeeds on the market, when this occurs, the good might be interpreted and hence categorized and marketed as a slight variation of some existing (exemplary) good. Occasionally, however, firms introduce goods that challenge, or are perceived by consumers to challenge the existing market categories or shared understandings of the good. These goods, when imitated, will become new exemplary goods; they will alter the way that existing categories are graded, i.e. they will make characteristics which were previously thought to be of minor importance focal, and formerly focal characteristics will become less relevant. The new exemplar might also challenge the boundaries between existing market categories. Finally, the challenge of existing market categories might result in the emergence of new categories.

Edward Chamberlin stressed the emergent product variation lamenting the deluded economist who has perhaps “been blinded” by “a system of thought which takes products as data and hence does not even raise the question of how they are determined” (Chamberlin 1953). But the issue also repeatedly appears throughout the works of Friedrich Hayek, who points out that economic

calculus – “the logic of choice” – takes the “apparatus of classification of possible human attitudes” for granted (Hayek 1948, 93).<sup>13</sup> Although both Chamberlin and Hayek recognized that the emergence of classifications is a central issue of economic competition, they are not very specific about how classification takes place, either.<sup>14</sup> We argue that the notion of exemplary goods is a significant step forward in the study of the competition process, but to avoid confusion we should further specify how exemplary goods fulfill this function. With this discussion we conclude our argument.

In the Lancaster framework, which still dominates most studies of quality in economics, producers choose the level of quality or the characteristics of goods. As a consequence, uncertainty about the goods asymmetrical, the producer knows, but the consumer is in the dark, and potential for exploitation of this uncertainty exists (Lupton 2005). In other words, firms “‘frame’ competition by focusing consumers’ attention on their best attribute (quality or price)” (BGS 2016, 481).

There are at least two alternative ways in which new exemplary goods, and their relevant characteristics may take shape. First, one might suggest symmetric variation of the standard model and argue that whether a new good – although introduced by producers in a trial-and-error process – will become exemplary, is ultimately determined by consumers. After all, consumers

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<sup>13</sup> Instead of taking assuming the existence of this network of focal exemplars and their mutual relationships, Hayek calls our attention to “the real problem” which seems to be “not whether we will get given commodities or services at given marginal costs but mainly by what commodities and services the needs of the people can be most cheaply satisfied” (Hayek 1948, 100–101). We cannot proceed assuming “a ‘given’ quantity of scarce goods”, the question of “*which things are goods* ... is precisely one of the conditions that competition should discover” (Hayek [1968] 2002, italics ours).

<sup>14</sup> Hayek ([1969] 1978) discusses the process of classification in terms of neuronal group selection.

pursue certain goals, and will seek the goods which help them best fulfill these goals. This approach lies at the heart of the alternative approach to consumer theory developed by Robert Michael and Gary Becker (Michael and Becker 1973; see also Stigler and Becker 1977). In their approach households seek to produce a fixed set of ‘commodities’, for which consumer goods are inputs (Foodstocks for example, are the input into the production of health). But while Lancaster fixes the essential characteristics of a good, this alternative Chicago approach has to fix the ‘commodities’ which households produce, and thus remain equally essentialist.

The second alternative takes into account the role of an agency that regulates quality. These agencies or regulators might take the quality determining process in their hands and, as Chamberlin points out, reduce the heterogeneity of qualitative characteristics by means of “standards and grades ... promulgated [for example] by the Federal government” (Chamberlin 1953). Alvin Roth (2015) wrote about the case of the US market in wheat that used to be characterized by much uncertainty about quality and provenance of the wheat. That is, until the Chicago Board of Trade implemented a uniform grading system in 1848. At that point the commodification of wheat, in the sense of the creation a set of rules that made a product standardized, thickened the market, and cut down on a variety of transaction costs. It was this particular categorization of wheat that was necessary for the commodification of grain that allowed large scale impersonal transfers in this good (Roth 2015, 16). In fact, Roth often quips that while God made wheat, it was the Chicago Board of Trade made the No. 2 Hard Red Winter (the set of rules that turned wheat into a more homogeneous commodity). This implies that it is not just the firm that can choose and implement the (efficient) focal qualities of their goods around which categories and classification schemes are built. In fact, a regulator such as a Board of Trade or a Federal government can choose. Acknowledging that setting standards of quality

might fall beyond the scope of the firm decision making is a major step ahead in the theory of consumer choice, it recognizes the importance of coordination between buyers and sellers. But Roth, focused on matching markets as he is, fails to consider why this grading system was accepted by buyers and sellers as legitimate in this particular instance, or indeed why in other instances we do not see more standardization, but instead more differentiation.

In other words, Roth fails to analyze the process by which such coordination comes about. Why are particular standards adopted? And why are particular differentiations successful? Although our theory of exemplary goods does not provide a way of identifying beforehand which goods will be exemplary, it does give insight into the way in which particular goods are linked together, and how firms and consumers understand similarities and differences between goods. As Barbara Smith argues in a different context:

Not only are the objects we encounter always to some extent pre-interpreted and preclassified for us by our particular cultures and languages, but also pre-evaluated, bearing the marks and signs of their prior valuing and evaluations by our fellow creatures. Indeed, preclassification is itself a form of preevaluation, for the labels or category names under which we encounter objects not only, as was suggested earlier, foreground certain of their possible functions but also operate as signs—in effect, as culturally certified endorsements—of their more or less effective performance of those functions. (B. H. Smith 1983, 23)

What matters for understanding people's choices in different situations – such as buying a beer in a beach resort as opposed to getting it from a corner store – is thus not the fact that one

buys a beer both times, as BGS emphasize, but rather the understanding by consumers of these situations.<sup>15</sup>

We have argued that competition is above all a process of opinion formation. While this argument recognizes that competition is a discovery procedure, it is not merely a discovery of costs and prices. This understanding is valuable but it takes an important part of the discovery procedure for granted. Ex ante, costs of doing things are not simply out there for the analyst – or an agent – to access and process. In the same way, the social categories that often seem solid and robust are in fact not given either, they have to be created too. In our particular cases, to take the market for coffee or biopic film-genre for granted is to confuse what is known ex-post, with what was uncertain ex ante.

We have shown that the existing structure of categories often obscures the acts of entrepreneurship that have contributed to the fine-grained differentiation that modern markets rely on. These acts of entrepreneurship do not just introduce new products to us, but also the way in which we should understand them. In this process of mutual coordination, the entrepreneurial actions of producers and consumers play an important role and it is in the interaction between consumers and producers that meanings are mutually coordinated so that some of them become focal, in other words, exemplary.<sup>16</sup> The market process is a discovery process, at least in the very

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<sup>15</sup> The situations we encounter are very often pre-classified or pre-evaluated through the linguistic conventions that we use. These conventions “indicate how one ought to respond to such circumstances”, in other words, “categories provide ‘instruction[s] for practice’” (Lewis 2016; Shackle 1992).

<sup>16</sup> Additionally, in many markets intermediaries of a wide variety, critics, marketers, early adopters, promoters and the like, play a prime role in the mediation of this discovery process (Bessy and Marie Chauvin 2013).

real sense, that knowledge of costs, prices and focal qualities around which categories of goods emerge becomes available.<sup>17</sup>

## **Conclusion**

Competition is not just a price-quantity discovering procedure through which resources are allocated to their most efficient uses. While competition *is* a discovery process, it is not merely a discovery of costs and prices; we argue that besides prices, relevant qualities of goods emerge from the competitive process as well. We further argue that qualities and their meanings are mutually coordinated and discovered in the interaction between consumers, producers, and intermediaries.

Our thesis offers an alternative to essentialist theories that assume goods belong to fixed product categories. We believe that a theory of goods that takes exemplars into account is more realistic with regard to the relevant factors that should be explained. The conceptual difference between essentialist and exemplary theories challenge the way in which economists generally distinguish between different goods and markets. Second, we challenge the way in which quality is usually considered in economic models where producers choose the level of quality (based on cost-functions). Producers neither have the power nor the knowledge to do so. Rather, producers – like consumers – are engaged in discovering the relevant characteristics and qualities of the good, which primarily emerge from the competitive process. Exemplars, a novel theoretical

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<sup>17</sup> Or as Richard Langlois and Metin Cosgel argue: “the economic problem of production becomes a coordination problem: discovering – or, rather, helping to create – an interpersonally shared structure of transaction” (Langlois and Cosgel 1998, 112).



concept we introduce here, play a crucial role in economic competition through which quality categories emerge.

Working with a salience model that operates with attention externalities (Bordalo, Gennaioli and Shleifer 2016), one needs to presume that all relevant characteristics are already known to both the consumer and the producer so as to conclude that consumers somehow make wrong decisions. If, on the other hand, we adopt the model of exemplary goods, with its associated ecological rationality, we can see that producers and consumers create and discover new relevant qualities and adjust their behavior accordingly.

We illustrated the process by which this happens with two case-studies. These cases clearly show that the relevant knowledge for improved decision-making by producers and consumers emerges in the competitive process. Biopics, as well as the new product offered by Starbucks, had not existed beforehand, so to argue that producers were foolish not to offer these products, or consumers for not demanding them, is essentially blaming them for today's failure to possess tomorrow's knowledge (Buchanan and Vanberg 1991). The problem is that tomorrow's knowledge is open ended and it is only with the benefit of hindsight, that is with knowledge which will have been created in the competitive process, that we can see whether the decisions made were optimal or not.

We invite further research into the problem of non-price coordination. How do entrepreneurs who break focal expectations contribute to the formation and emergence of new exemplars and classification schemes? How does innovation upset existing classification schemes and traditional boundaries between market categories? We believe that the theory of exemplars will help us better understand how markets emerge by answering the question of what is actually being traded. What the good is should no longer be taken for granted.

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