The Cost of Breaching an Implicit Contract*

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Abstract

We offer evidence on the magnitude of the cost of breaching an implicit contract in the goods market, building on Young and Levy (2014) who document a presence of an implicit contract in the case of the rigidity of Coca-Cola's price in the US during 1886–1959. The implicit contract promised a 6.5oz Coke of a constant quality, *the real thing*, at a fixed price, 5¢. We offer two types of evidence. In the first, we document a case where the Coca-Cola Company chose to incur a permanently higher marginal cost of production in order to prevent a quality adjustment of Coca-Cola, because quality adjustment would be considered a breach of the implicit contract. In the second, we explore the consequences of the Coca-Cola Company's decision in 1985 to change its "secret formula" by introducing the New Coke to replace the old (Classic) Coke. Analyzing the market's reaction to the change, we demonstrate that the unprecedented angry public outcry that followed the New Coke's introduction was a direct response to the Company's breaching of the implicit contract it had nurtured for decades with the American public. We offer evidence that the change in the secret formula that accompanied the introduction of the New Coke was perceived by the market as a *betrayal*, as a break of its long-held promise, and thus a breach in the Company's implicit contract with its loyal customers. We document the direct costs the Coca-Cola Company incurred to implement this quality change, and demonstrate that the indirect costs as measured by the lost customer goodwill it brought about were substantial. Using the framework of Hirschman's (1970) model of exit, voice, and loyalty, we analyze the behavior of US consumers in the days that followed the introduction of the New Coke, and discuss possible implications.