Market Failure or Success

The New Debate

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9. The demand for and supply of assurance[1]

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QUALITY AND SAFETY RESTRICTIONS

Many agree that the consumption and production of bread are best left to voluntary processes. But many who favor free enterprise for such tangible goods oppose it for matters of quality and safety. The economist Jerome Rothenberg (1993) says: 'The market's myriad decentralized actions do not themselves ensure adequate safety. Centralized controls of various sorts are needed. These have been instituted in the form of regulations, constraints, information programs, licensing and certification' (172). Sometimes economists and others espouse quality and safety restrictions such as housing codes, occupational licensing, pharmaceutical approval, consumer product recalls, financial exchange regulations, and workplace safety regulations. I will offer a formulation of these matters that suggests that the broad reasons we favor free enterprise in bread carry over to quality and safety issues.

TRUSTERS AND PROMISERS

Many transactions involve promises of quality and safety that cannot be fully verified before the fact. One party decides whether to trust the other to deliver what is promised. A consumer decides whether to trust the grocer or pharmacist or mechanic to deliver the quality promised. A merchant decides whether to trust a prospective employee. A landlord decides whether to trust a prospective tenant.

The canonical example is a creditor deciding whether to trust a borrower who promises to repay the loan. The trust relationship is clarified by Figure 9.1. Truster (the creditor) decides either to trust or not trust Promiser (the prospective borrower). If Truster decides to trust, then Promiser decides whether to keep his promise or to cheat. If he keeps his promise, then both parties achieve a happy outcome – each receives a payoff of 1. If Promiser cheats, he gets a payoff of W and leaves Truster with a payoff of –1. But if

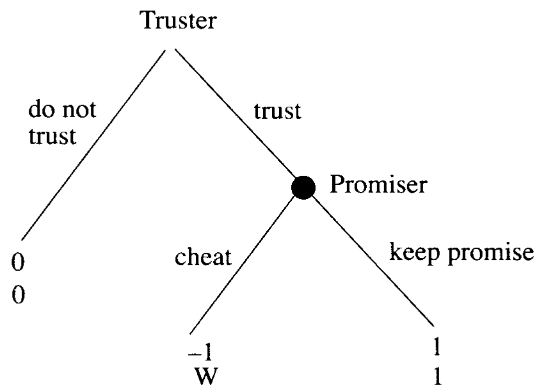

Figure 9.1 Truster decides whether to trust Promiser

Truster initially suspects that W is greater than 1, then she suspects that Promiser will cheat, and she decides not to trust in the first place. Deciding not to trust results in a payoff of zero for both players. A lack of trust is a social tragedy because it prevents society from achieving outcomes in which everyone is better off.

I employ the following analytic scheme:

- Promiser communicates the content of the promise.
- Truster heeds any of a variety of *assurances* of Promiser's trustworthiness.
- Truster thereby forms a level of *confidence* in Promiser's trustworthiness.
- The parties make the decisions as depicted in the Figure 9.1.

The parties may deviate from this scheme in many ways. They may negotiate the promise or restructure the relationship. They may make fulfillment incremental rather than all-at-once, withhold payment until the promise is fulfilled, demand a security deposit, commit collateral, or attach a warranty or guarantee. But with suitable interpretation, every transaction that entails an element of trust may be viewed in the manner suggested above.

THE DEMAND FOR ASSURANCE

Truster owns a car and the muffler is falling off. A local auto shop promises to do repairs honestly according to estimates. Truster seeks to produce for herself confidence in the promise, enough confidence to trust Promiser and to feel she has trusted responsibly. The inputs to her confidence production are any of the variety of assurances of trustworthiness. Thus, the entertaining of a promise ushers in a *demand for assurance.*

In the free enterprise system the demand for X tends to create opportunities for entrepreneurs to profit by supplying X.[2] When X is bread or toothpaste, we put a lot of stock in this dialectic. But when it comes to assurance, some academic economists suggest that information asymmetries and externalities cause free markets to 'fail.' The Nobel economist Kenneth Arrow (1974) says: 'Trust and similar values, loyalty or truthtelling, are examples of what the economist would call "externalities" . . . They are not commodities for which trade on the open market is technically possible or even meaningful' (23).

Too often, economists conceive of demand and supply in narrow terms – as the exchange or delivery of something the quantity of which can be measured along a horizontal axis. Equilibrium models (such as textbook supply-and-demand) blinker our understand of that intangible and highly particularistic transaction cost, assurance.[3] As noted, the demand for assurance corresponds to particular promises, so in making the final decision about auto repairs, Truster assesses the combination:

> (Thing-promised and its price, Confidence (Assurance), Other transaction costs)

Economists have neglected the corresponding demand for assurance. They have neglected the range of entrepreneurs (including the truster and the promiser themselves) who may find profit in supplying assurance.[4] My contention is that the free enterprise system mobilizes an impressive, complex array of techniques to supply assurance, techniques which in one fashion or another overcome or circumvent any of the particular pitfalls stressed by market-failure theorists and other pessimists. Even for assurance, the essential dialectic holds up well, and restrictions, which are often very costly,[5] are typically unredeemed.

The supply of assurance uses many methods and takes many forms. I attempt to catalog the more important methods.

POINTED KNOWLEDGE CAN OBVIATE THE ROLE OF TRUST, OR PROVIDE A WARRANT FOR IT

The woman with the broken muffler seeks pointed knowledge about how to restore her vehicle to road-worthiness. In inquiring about her broken muffler, the woman may come to apprehend the technical measures required; she may even find that she is able to fix it herself. If she can trace a good information path, information is less asymmetric, and she might circumvent the need for trust.

But information that does nothing, in the narrow sense, to reduce asymmetry may be precisely what the woman needs. The woman may seek to discover not what is wrong with her muffler, but simply *who is an honest serviceman.* Her pointed knowledge may not provide a direct demonstration of quality, but rather an assurance of quality. Similarly, in rhetoric, our warrant for an idea may be, not a direct demonstration of its validity, but its endorsement by a trusted authority. The information she obtains may tell her, not about how her automobile operates, but how the serviceman operates. Assurance itself becomes a valued input to the transaction, and those who can provide it will tend to prosper.

In any sort of personalized service, an important factor is face-to-face contact. By talking we may get a clearer understanding of the content of promises. Clarity, repetition, and publicness reinforce accountability. Often personal rapport is a part of the experience characteristics or necessary to informed treatment.

Even when trusters have little technical knowledge of the trouble, they can get an impression as to whether the promiser is trustworthy. It is always a good sign when the promiser takes pains to explain why the trouble is occurring and what the various options for remedy are. An understanding of the trouble usually comes down to a few basic relationships. Explaining the situation helps to inform the truster and creates a measure of accountability for the promiser.[6] In a wide range of contexts the Internet is making it easy to probe the content of promises and integrity of promisers. Broadband technologies enable virtual face-to-face interaction.

INFORMAL CHANNELS OF INFORMATION SHARING

The housing development where I used to live has a home-owners association that issues a monthly newsletter. In one issue there appeared recommendations for a plumber, a painter, an electrician, a Volvo mechanic, a window cleaner, a carpet cleaner, a piano tuner, a woodworker, a brick-layer, a cabinet builder, a nanny, a handyman, a house cleaner, a furniture transporter, a floorer, two garage door servicemen, and seven house cleaners. My neighbors provided the recommendations, acting individually and giving their own phone numbers for details. People in the neighborhood know each other well enough to doubt that anyone would take a bribe to recommend a lousy nanny or handyman. The recommended individual is quite likely to be an illegal practitioner, even an illegal alien.

The newsletter serves as a sort of community concierge that directs members down happy information paths. The newsletter column exists because there are information problems to be solved. No one would get good-neighbor points or that pleasant helping feeling for helping to solve a nonexistent problem.

The newsletter is a kind of local gossip. Gossip arises among family, friends, acquaintances, neighbors, and coworkers. It takes the forms of chatting, group meetings, correspondence, leaflets, bulletin boards, newsletters, local newspapers, Internet websites and e-mail. Anthropologist Sally Merry writes, 'gossip can be viewed as a means of storing and retrieving information.' 'It forms dossiers on each member of one's community: who is a good curer, who can be approached for loans . . . who is a good worker, and who is a thief.' In consequence, 'the individual seeks to manage and control the information spread about him or her through gossip' (pp. 275, 279). In the marketplace, promisers do likewise by maintaining quality. A study of consumer complaints against Coca-Cola products found that, of complainers unsatisfied with the company's response, the median told nine other people about her unsatisfactory experience (TARP, 1981, 14).

EXTENDED DEALINGS

Continuance, repetition, or information sharing – any of which are what I call *extended dealings* – open up vast institutional possibilities and provide fertile ground for trust. Our power to damage a promiser's reputation or to withdraw from dealings serves as a hostage that we hold against his promises.[7] Career promisers build and protect their reputation, sensing the truth in the saying, 'Time wounds all heels.'

Gossip, letters of recommendation, newsletters, data banks, consumer survey literature, information reporting bureaus, and referral agencies all make for extended dealings. These practices serve not only those trusters who make use of them, but also those who do not. Although a promiser often knows whether a particular truster has frequent dealings, he rarely knows whether the truster has extended dealings. The promiser does not see the truster gossip, and therefore, except in rare cases like the hapless motorist who pulls off the interstate for sudden repairs, the promiser must treat every truster as one who might be extending information to others. Lackadaisical trusters gain by the presence of pernickety trusters (except when they are being pernickety while we are waiting in line). Extended dealing exhibits positive externalities among the set of trusters, and there is an argument for government facilitation or performance of such services (Beales and Salop, 1980). But even though this sort of free-riding among the trusters does occur, the informed portion of the clientele does create a margin of punishment and reward, a margin that favors the trustworthy in the contest for commercial prosperity.

Extended dealings might benefit even trusters known to have isolated dealings. In the marketing of a standardized product, promisers cannot deal with trusters selectively. Even for services, protocol and the force of habit – including moral habits – usually keep the promiser honorable even when he knows that cheating would go unpunished (other than by his conscience, that is).

TRUSTWORTHY PROMISERS CULTIVATE EXTENDED DEALINGS

Wary trusters share information, but the practice is unwelcome only by the promisers who are not trustworthy. Trustworthy promisers welcome information sharing and, where permitted by law, tend to organize themselves to facilitate and expand the extension of dealings.

There are two ways in which a trustworthy promiser gains reputation by having a large base of trusters with extended dealings. First, when extended trusters are satisfied, they increase their own patronage and spread the good word. In his book *Industry and Trade*, Alfred Marshall (1927, 297) referred to 'that highest form of advertisement, which comes from the recommendations of one customer to another; and from the inducements which dealings with one department offer to dealings with another.' Second, promisers who enjoy a large extended base attract new, nondiscriminating trusters merely by the fact. Less pernickety trusters are attracted to a promiser with a large extended base because they know that such a promiser has strong reputational incentives to make good, and that trustworthiness has probably been a means by which he achieved his standing.

THE UMBRELLA OF THE BRAND NAME

In the late 19th century, as transportation systems and mass production created a national market in America, consumers confronted 'a profusion of unstandardized packaged goods . . . [and] unfamiliar selling and processing techniques,' making it hard for them to judge such qualities as 'the freshness of food or the durability of clothing.' The consumer historian Norman Silber continues:

> To ease the minds of customers about problems of quality, reliability, and safety, manufacturers and advertisers appealed to consumers to buy according to brand names. National Biscuit, Heinz Soup, Armour Meat, Standard Oil, and other companies placed one banner on many different products. The consumer who found one product of a brand to be satisfactory, those companies suggested, could assume that all other products also would be suitable. (Silber 1983, 3)

A brand name is a way of gathering together an array of services that make for frequent dealings. The array will be shaped by finding a fit with the tastes of the clientele (as well as by scope economies). Game theorists tell us that repetition makes for good offices; hence promisers try to enhance repetition.

A machine-tool company such as Black & Decker makes hundreds of different products, but its customers will generalize to some extent about all of them based on their experience with only a few (see Goodman, Broetzmann, and Ward 1993 on customer satisfaction and brand loyalty). By enlarging its product base the company creates frequent dealings with many of its customers, giving them a better opportunity to evaluate its trustworthiness. In this way, Black & Decker becomes a provider of assurance, as well as tools. The inventor-genius may create, *de novo*, in his basement workshop a fantastic new tool, but it is not a great *product* until it is combined with assurance. The inventor may find it advantageous to sell his invention to Black & Decker and let the firm offer it under the umbrella of its brand name. In a sense, Black & Decker is the expert that tells the truster that the new gizmo is trustworthy. Black & Decker is not merely a manufacturer, distributor, and advertiser, it is also a *knower* that grants its own seal of approval. A 'knower' is anyone who knows valuable information about the promiser's trustworthiness (in this case, the inventor's).

DEALERS MAKE FOR EXTENDED DEALINGS

Besides generating extended dealings with consumers, Black & Decker is at the center of a starlike pattern of dealings with scattered inventors. Consider the similar case of the used car dealer. The used car dealer might have only isolated dealings with the sellers of used cars (like Black & Decker has with some inventors). But, unlike ordinary individuals, he knows all about cars and deals on an equal information footing with the seller. By gathering up a stock of used cars from an array of isolated sellers, the dealer produces a fixed lot of cars and a basis for extended dealings with buyers. Although he does not have many frequent customers, the dealer is a fixture in the community and a subject of gossip. A buyer gets to know her car intimately, and if it disappoints her she will gossip. Also, the dealer can offer guarantees and warranties. The dealer, then, besides reducing transaction costs and upgrading the commodity, transforms a series of isolated dealings – many dyadic matchings between a buyer and a seller – into the starlike pattern shown in Figure 9.2.[8]

Dealers often have credentials that enhance credibility. The infrequent buyer feels that she can trust the credentialed dealer because the credential is a costly, irreversible investment. The truster is assured that the dealer has an incentive to protect his reputation, because he has the option of reaping the

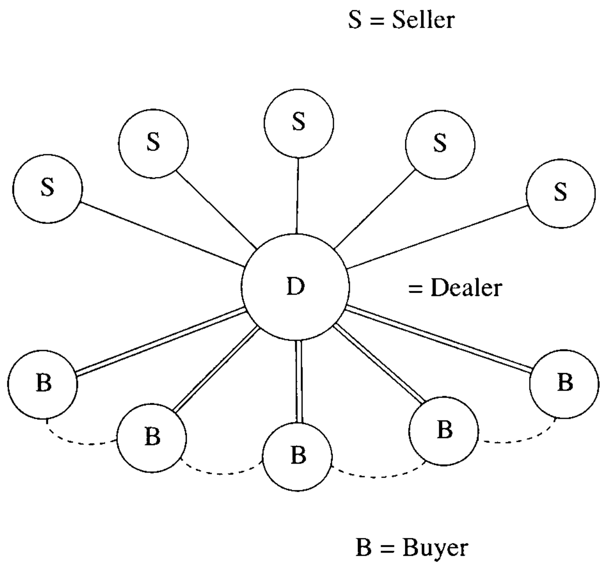

Figure 9.2 *The dealer has a star-like pattern of dealings. With sellers he deals on an equal informational footing. Once he has gathered the goods he has extended dealings with buyers.*

returns of honest and competent dealings (Marshall, 1927, 270; Klein and Leffler, 1981; De Long, 1991; Nichols, 1998). Economist Gary Biglaiser (1993, 221) says: 'Coin and stamp dealers display to the public that they belong to dues-paying professional societies and are certified numismatists and philatelists . . . Many used-car dealers train mechanics to check and maintain car quality. If the dealers cheat customers and go out of business, then the investment in their employees' human capital is lost.'

REPUTATIONAL NEXUS AND THE MIDDLEMAN

My confidence in a house cleaner is strengthened by a neighbor's recommendation. My confidence is made still stronger by my neighbor's continued dealings with the house cleaner. Our relationships form a *reputational nexus*, a constellation of extended dealings. By acting discreditably, the house cleaner would damage her relationships both with me and with the neighbor.

Reputational nexuses exist in the family, the church, the social club, the neighborhood, the workplace, and the marketplace, creating a vast netting between the social patchwork. Social network theorists figure that any pair of

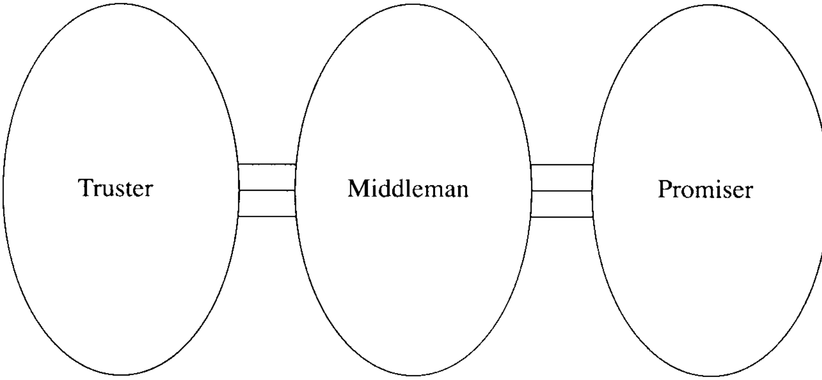

Figure 9.3 The middleman creates a bridge of trust between two traders

adult Americans can be linked by three or fewer intermediary acquaintances (Pool and Kochen, 1989, 16).

The ordinary retailer, who serves as the link between the consumer and the producer, demonstrates the reputational bridge. Many of the matches between consumers and producers are irregular – as when a consumer purchases an ulcer medication – but the consumer has extended dealings with the pharmacy, which in turn has extended dealings with the producer. As the economist Janet Landa (1994, 125) says, 'the middleman . . . mediates between traders . . . who do not trust each other but mutually trust the middleman.' The middleman creates a bridge of trust between two traders (see Figure 9.3).

The private, liberal-arts college is a middleman. It contracts with the ultimate promiser – the professor – and tries to build a reputation for general quality with trusters – students and parents. The firm, the chain-store, and the trade association are all different species of contract nexus. Simple contracting can produce assurance in much the same way that a chain-store does. The health care organization contracts with physicians and hospitals: the patient has extended dealings with the HMO, and the HMO has extended dealings with the physician. The reputational role of the HMO ranges over a contractual continuum, from employment within the firm (the staff model), through intermediate stages (group practice, individual practice associations), to selective contracting with health care providers (Wagner, 1989).

THE MIDDLEMAN ALSO ACTS AS KNOWER

Besides straddling two extended relationships, the middleman also acts as a knower. The retailer specializes in knowing good products from bad – by recognizing brand names and seals of approval, studying the information on labels and packaging, keeping track of customer complaints and returns, conducting his own tests and investigations, hiring testing services, following trade or consumer literature, observing whether other retailers carry the product, and chatting with industry colleagues.

In his role as knower, the middleman works in information that is often too costly for the consumer to gather and judge herself (Pashigian and Bowen, 1994). In a sense, the premium she pays to the middleman, whether he is an established retailer, a brand-name manufacturer, or a contracting organization like an HMO, is a fee for the luxury of being uninformed yet assured.

No commodity is entitled to a strong market; it must concede its dependence on the services and institutions that produce recognition and assurance. Effective middlemen, such as Nordstrom's clothing stores, sell more of the product and at higher prices. Manufacturers respond by seeking to have their products carried by such middlemen. (Notice that, like Landa [1994], I am using the term 'middleman' in a sense that is much broader than the common usage, of one in between the manufactuer and the retailer.)

The two end points of the reputational link, the manufacturer and the consumer, both have an incentive to avoid the prisoner's dilemma outcome. Among the diverse, complex, and imperfect institutional experiments that take place in a free and open field, trusters and promisers will favor and sustain those experiments that produce assurance. Middlemen and knowers strive to produce it, because their cut comes from happy trusting outcomes.

KNOWER SERVICES: FEE FOR INFORMATION

We might view gossiping as a sort of exchange. Exchanging information with acquaintances is one basis for our personal relationships. Information provision by gossip comes to be seen as a trade and as a source of profit. But the economist Hayne Leland (1980, 268) says, 'information on quality has many aspects of a public good: a consumer can give it away and still have it. Under such circumstances, inadequate resources will be channeled to providing information.'

Information provision can be divided into generation and conveyance. Information generation takes the forms of testing, inspecting, researching, evaluating, or interpreting. Consumers Union does all of these when generating product ratings in *Consumer Reports*. Consumers Union makes profits by selling its magazine to trusters. Is its information a public good? Once one person has the ratings, she can indeed share them with her friends and acquaintances – she may even sell her expertise in some manner. But the law forbids her from reproducing or selling the information. The information is proprietary and to a good extent excludable.[9] If you can protect information at the conveyance stage, then you can appropriate its value at the generation stage.

Excludability is often achieved in large measure by legal sanctions. Yet often excludability is simply a matter of technical limitations on the part of would-be free-riders. Information conveyance requires information receiving, organization, storage, retrieval, and transmission. Credit bureaus such as Experian, TransUnion, and Equifax sell credit reports to trusters. They make profits by facilitating dealing, just as Manhattan parking entrepreneurs make profits by facilitating shopping. Experian releases valuable information to millions of parties every month, but that does not mean that they can appropriate the value of the information by reselling it. Experian provides highly individualized information. It makes information complete, speedy, and precise. For someone to free-ride on Experian by entering and competing, she would have to invest in vast data-processing systems. Kenneth Arrow jumps to conclusions when he says that in the absence of special legal protection, entrepreneurs cannot profit by selling information.[10] Like the private parking garage, the service performed by Experian is largely excludable.

Consumers Union reports on standardized products, and its conveyance of information is uniform, not individualized. In consequence, it would be damaged by free-riding if its information were not protected by law. Experian deals in information of a more particularistic nature, namely credit records, and its conveyance is individualized. Its information is protected by the technical limitations of whoever might think of reselling the information, as well as by contractual protections and federal law. Whenever quality information is individualized, the opportunities for *re*conveying it are limited. Thus knowers can make money by being hired by trusters to inspect customized security equipment, manufacturing plants, and used automobiles; to give second opinions on medical matters; and to evaluate prospective employees (Rees, 1966). And the beloved kibitzer can keep up a steady trade in local gossip because others cannot receive, interpret, organize, retrieve, and transmit information nearly as well as he can.

Kenneth Arrow has pointed out that trade in information is often hobbled by the fact that the 'value of information is frequently not known in any meaningful sense to the buyer; if, indeed, he knew enough to measure the value of information, he would know the information itself' (1963, 946). In the case of *Consumer Reports* or Experian, however, the buyer does have a good idea of the value of the information she is purchasing, even though she does not know the information itself. Granted, the consumer cannot measure the value *perfectly* without in fact having the information, but she might know the range of the value, or the expected value. In this respect, *Consumer Reports* is like the *New York Times* or a Stephen King novel or a movie ticket.

SEALS OF APPROVAL AND SELF-DISCLOSURE BY PROMISERS

When a knower generates basic quality information on a standardized product of interest to a wide class of trusters, reconveying the information might be easy, and he may go broke trying to sell information to trusters. In that case he goes to work for the promisers (Beales and Salop, 1980). If a lack of parking spaces would prevent customers from coming to buy, and an independent parking entrepreneur could not exclude nonpayers, then the retailer would himself provide space for customer parking, at no charge. Similarly, if a lack of information would prevent trusters from entering into deals, the promiser provides the information. If his quality is high, he has every incentive to self-disclose far and wide.

Pauline Ippolito (1986, 23) remarks on how sellers self-disclose:

> Low tar and nicotine cigarette sellers have been vigorous in distinguishing themselves from the higher tar brands (going far beyond the mandated disclosures in advertisements). High mileage automobiles often feature this fact in their advertisements. Lower calorie foods (especially in the diet soda and frozen food categories) have been very successful in conveying their superiority to higher calorie counterparts. The same is true for high fiber foods.[11]

Sellers strive to demonstrate or indicate the uses, conveniences, durability, or special pleasures of their products or services.[12] They set up displays, employ salespeople to demonstrate and describe the product, advertise product characteristics, recruit referral agencies, and offer guarantees and warranties (which in Grossman's model [1981] lead to perfect disclosure). Assurance is a necessary input to the consumer's own production of confidence.

That the provision of information may exhibit public-goods characteristics is not a curse to promisers but a blessing. An independent knower often evaluates quality or safety. If the word is favorable, the promiser broadcasts it. Computer and automotive advertisements tout 'editor's choice' accolades, household products display the *Good Housekeeping* seal of approval, movie ads reproduce favorable excerpts from the critics, restaurants display favorable dining reviews. Gerald O'Driscoll (1976) argues that the American Express sticker on a merchant's window is a seal of approval.

Electronics manufacturers hire Underwriters' Laboratories to test and inspect their products and grant a UL mark upon approval. Companies and governments hire Moody's to rate their securities and use the ratings to market their securities.[13] Promisers assure trusters by advertising in media that police integrity – a strategy first employed against the quackery of patent medicine by *Ladies' Home Journal* (Calkins 1928, 49). Another class of knowers paid by promisers, particularly relevant to the issue of occupational licensing, is made up of professional schools, technical schools, institutes, and training programs that grant degrees and certificates. These credentials are then prominently displayed on office walls and listed in *curriculum vitae*. Transcripts and honors give a sort of rating system. Each of these organizations grants its own seal of approval.

Research on seals of approval has suggested that seals like the UL mark are not really understood by consumers and do not significantly enhance the consumers' confidence in the product (Parkinson, 1975; Beltramini and Stafford, 1993). Researchers show test subjects advertisements with and without seals of approval, and see if subjects have greater confidence in the ads with seals of approval. Such research is flawed for several reasons. First, assurances might gain meaning only to consumers genuinely interested in the promise. Unlike genuine prospective buyers, test subjects do not have an interest in the particular products advertised, and hence do not have the incentive to gain pointed knowledge about relevant signals of quality. The research also says that consumers poorly understand seals of approval, because they do not know on what basis the seal is awarded. But again, pointed knowledge for the consumer is knowledge of whether products with the seals are more likely to be satisfactory, not formal knowledge of how seals are awarded. Knowledge of how seals are awarded might be known to only a few, but those few may provide the base upon which an inverted pyramid of divided knowledge is sustained, making the seal an effective signal to those farther up the pyramid who use only very limited pointed knowledge. In other words, advertising credibility may not be the relevant test of a seal's value: the seal may be most important to the distributors, retailers and other middlemen who decide whether to carry the product.

FRANCHISES AS A SYSTEM OF SEALS OF APPROVAL

When a motorist pulls off the interstate and into Joe's Garage for sudden repairs, she will have isolated dealings with Joe and feel vulnerable. The motorist would do better to pull into Midas, Shell, or Mobil, because if the local Midas franchisee cheats her, it faces the prospect of punishment. Punishment would come, not from her (the motorist), but from the franchisor, who polices the service and probity of their franchisees using 'mystery shoppers,' audits, inspections, and complaint investigation. They *do* have to fear that the customer will harm them by not returning or by injuring the franchise's reputation.

The franchisor is a knower that provides a seal of approval. When the serviceman wearing the Midas shirt and cap approaches us, he is not our connection to Midas. Midas is our connection to him. Midas is like a friend, and the serviceman is the friend of a friend. Although it is mutually understood that the motorist and the Midas franchisee will be interacting only once, the motorist has extended dealings (of an indirect sort) with the franchisor, who in turn has extended dealings with the franchisee. A franchise operation succeeds partly by capitalizing on product familiarity and low-cost replication of a successful formula, but also by producing that intangible input to mutual gains, assurance.

A CLASSIFICATION OF INDEPENDENT KNOWER ORGANIZATIONS

Two distinctions aid us in thinking about knower organizations: first, whether the knower is engaged in information generation or conveyance (or both); and second, whether the knower is remunerated by trusters or by promisers. Using the two distinctions we get a classification scheme as shown in Figure 9.4.[14]

WAYS OF APPREHENDING UNTRUSTWORTHINESS

Trustworthy promisers have every incentive to self-disclose. But the untrustworthy do not strive to self-disclose; in fact, they have a special incentive to deceive. How do trusters apprehend the untrustworthy?

One way is to ask for a public elucidation of the content of the promise. If they fudge and prevaricate, suspicions arise. Perhaps even more telling are the accolades, coveted seals of approval, and glowing endorsements that are not. When we view a *curriculum vitae*, a meagerness of distinctions will make itself evident and lead us to doubt outstanding ability. Similarly, trusters remain wary when they do not hear any of the wide variety of horns that trustworthy promisers blow in self-disclosing. It is precisely because the horns are unavailable to untrustworthy promisers that they are effective signals of quality.

One sort of evidence is the demonstration of traits distinctive to trustworthiness, such as announcing, 'Established in 1924,' or promotional efforts lucrative only for a worthy promise (Klein and Leffler, 1981). Before the Federal Deposit Insurance Corporation was created to bail out banks, banks had traditionally used large pillars and heavy marble in their architecture to signal permanence. Another way to apprehend untrustworthiness is to hire knower services. Hired inspectors, *Consumer Reports*, Dun & Bradstreet, Experian, Roger Ebert, and the neighborhood gossip all report on the trustworthy and untrustworthy alike.

A third way of apprehending untrustworthiness is forged by competitors.

Knower engages in information	Knower is remunerated by: Trusters	Knower is remunerated by: Promisers
Generation	Hired inspectors (for buildings, automobiles) Letters of recommendation Doctors Financial advisors Hired investigators American Automobile Association	Credential givers (universities, institutes, training programs) Underwriters' Laboratories American Dental Association *US Pharmacopoeia* Good Housekeeping Security ratings (Moody's, Standard & Poor's) Securities underwriters Financial and accounting audits Notary public Letters of recommendation Orthodox Union (kosher foods) Internet seals of approval (TrustE, Cyber Patrol, Safesurf, Verisign, BBB Online)
Generation and conveyance	*Consumer Reports* Dun & Bradstreet Industry newsletters Hobby, product, and news publications Restaurant and movie reviews Employment agencies Brokers Internet chat groups (eBay)	Franchises Better Business Bureau Medical data banks Employment agencies Brokers (securities, real estate, produce, art, collectables)
Conveyance	Gossip, e-mail Consumer credit bureaus	Referral services Advertising firms Signs, labels, packaging, displays, sales help Web pages

Figure 9.4 Classification of knower services

Promisers expose the poor characteristics of competitors' products, if only by insinuation, in advertisements, sales demonstrations, and marketing literature. Before the imposition in 1971 of restrictions on cigarette advertising, advertisements for low-tar brands sometimes pictured rival brands and listed the tar content beside each. Many researchers think that the restrictions have inhibited the market for low-tar cigarettes.[15] Competitive advertising is a great service to trusters, as it helps them discover product differences and the validity of product claims.

In his 1928 book titled *Business the Civilizer*, advertising executive E.E. Calkins wrote of an early case of competitive exposé:

> Dr. Lyon's Tooth Powder and Colgate's Dental Cream are both using their advertising space to offset undue claims instead of stretching them further. That is one of the values of advertising. It will correct itself. The lying advertisements will find themselves surrounded by truth and will be forced back in line by the weight of public opinion. (284)

Of the 65 advertising challenges resolved by the Better Business Bureau's National Advertising Division in 1992, almost all of which dealt with the truth and accuracy of advertising claims, 72 percent were brought by competitors.[16]

In the areas of health care and pharmaceuticals, competitive exposé is restricted – drug manufacturers are not permitted to report findings about their own products, much less their rivals'. A robust arena of self-disclosure and competitive exposé, also known as free speech, would help trusters gain the opportune, pointed knowledge they can really use (Ippolito and Mathios 1990, 479; Russo *et al.* 1986). In his famous paper on the market for lemons, George Akerlof (1970, 495) suggested that sometimes 'dishonest dealings tend to drive honest dealings out of the market.' Freedoms to engage in self-disclosure and competitive exposé – and, first of all, to enter and exist as a trustworthy alternative to the lemon – are what best ensure that honest dealings drive dishonest dealings out of the market.

INTEGRITY AND HAYEKIAN DIALECTICS

Economists have explained the coordination of promises but have done much less to explain the integrity of promises. The integrity issue looms larger as society becomes more complex. 'The more civilized we become, the more relatively ignorant must each individual be of the facts on which the working of his civilization depends. The very division of knowledge increases the necessary ignorance of the individual' (Hayek 1960, 26). Increases in the division of knowledge imply the growth of our dependence on things unknown to us and of the role of trust in economic affairs.

But the answer to our question *What explains promise integrity*? turns out to be, excepting the tort-enforcement explanation, a special instance of the answer to the original question *What explains promise coordination*? People truck, barter, and exchange, utilizing their local knowledge. To assure that promises will be kept, other promises are made. There is a demand for and supply of assurance:

> In actual life the fact that our inadequate knowledge of the available commodities or services is made up for by our experience with the persons or firms supplying them – that competition is in a large measure competition for reputation or good will – is one of the most important facts which enables us to solve our daily problems. The function of competition is here precisely to teach us *who* will serve us well: which grocer or travel agency, which department store or hotel, which doctor or solicitor, we can expect to provide the most satisfactory solution for whatever particular personal problem we may have to face. (Hayek, 1948, 97)

But doesn't the 'assurance industry,' while supposedly solving one trust problem, simply create other trust problems? The manufacturer, wanting retailers to trust his microwave oven, contracts with Underwriters Laboratories, but how do we know we can trust UL? UL would stand to lose much if, by compromising integrity, its reputation were injured. Hence it would be incorrect to say that the division of knowledge implies a constant amount of vulnerability, or constant amount of doubt. No such conservation principle holds, because in the competitive processes of voluntary affairs, assurances tend to be shifted to the ground where they are strongest.

The Internet is vastly expanding all forms of information exchange and assurance. When critics find some fault in e-commerce, such as doubts about privacy, security, or trustworthiness, entrepreneurs invent an e-solution, usually taking the form of a middleman service or a knower service.

Intellectuals, commentators, and regulators working on quality and safety regulation should seriously consider how resourceful middlemen, expert knowers, trustworthy promisers, and wary trusters find ways to overcome virtually any of the supposed failures of the free enterprise system. The demand for assurance brings forth a supply of assurance.

NOTES

1. This chapter is a revised and expanded version of the paper bearing the same title that appeared in *Economic Affairs*, March 2001, pp. 4–11.
2. The terms 'demand,' 'entrepreneur,' 'profit,' and 'supply' are being used in broad senses.
3. Whether we ought to regard assurance as a transaction cost depends on how exactly we define transaction cost. If transaction costs are simply costs (other than price paid to the seller) of completing a transaction, assurance is not a transaction cost. But if transaction

costs are costs (other than price) of coming to, assessing and completing an *ex-ante*-worthwhile transaction, then assurance is a transaction cost.

4. The neglected has been by no means entire. Many types of research may be credited here, but five come especially to mind: (1) empirical studies of reputation and its value, (2) game-theoretic models of reputation, (3) consumer and marketing research on various certifiers and 'knower' organizations, (4) studies of customs and norms elicited and sustained without (or even in the face of) governmental legal authority, and (5) libertarian explorations of how assurance has been, is, or would be provided in the absence of government intervention. For a Schematic Bibliography see Klein (1997).
5. Large literatures exist on each of the quality-and-safety interventions noted above. I read the bulk of this research as indicating that these policies have high costs with few corresponding benefits. For a review of the literature on occupational licensing, for example, see Svorny (1998), on workplace safety see Magat and Viscusi (1992), on the Food and Drug Administration, see Klein and Tabarrok (2001).
6. However, chatting might reveal to a cunning promiser that the truster is naive, ignorant, or powerless.
7. Common usage of the term 'reputation' is sometimes at variance with my usage. In my usage, someone recognized for faithfully delivering the quality promised has a good reputation, even if that quality is regarded as low. My usage focuses on keeping the promise, not on what is promised. But the content of the promise is formed in large part by the quality that people come to expect, so my usage, in fact, addresses the broad notion of 'reputation for quality' better than it might at first seem. Attached to every Nike product is the implicit statement: 'and we promise that it is of Nike quality.'
8. Economist Eric Bond (1982, this volume) studied the market for used pick-up trucks, looking for lemons-market results, and found none. He reports (p. 839): Pick-up 'trucks that were purchased used required no more maintenance than trucks of similar age and lifetime mileage that had not been traded.' It would be interesting to learn whether used vehicles purchased from dealers require less maintenance than those purchased from isolated individuals.
9. *Consumer Reports* states its position in each issue: 'Neither the Ratings nor the reports may be used in advertising or for any other commercial purpose. Consumers Union will take all steps open to it to prevent commercial use of its materials, its name, or the name of *Consumer Reports*.' Silber (1983, 31) notes that in the 1950s '[a]ttorneys successfully protected the ratings of the magazine from unauthorized use by commercial interests.'
10. 'In the absence of special legal protection, the owner [of information] cannot, however, simply sell information in the open market. Any one purchaser can destroy the monopoly, since he can reproduce the information at little or no cost' (Arrow, 1962, 151).
11. Ippolito and Mathios (1990, 479) examine the effect of the removal in 1984 of a ban on health claims in the cereal market: 'The evidence clearly demonstrates that fiber cereal consumption increased once the ban on health-claims advertising was removed. The development of fiber cereals also increased when producers were given the ability to advertise the health features of the products. Moreover, advertising appeared to reduce some of the differences across the population [of cereals], suggesting that advertising may have had its effects by reducing the costs of acquiring information.'
12. Beales, Craswell and Salop (1981, 502f) offer a good discussion of self-disclosure, as well as of imperfections in the quality-information market generally.
13. Viscusi (1978) provides a model of quality certification which yields a happy outcome, in explicit contrast to the unhappy outcome of Akerlof's model (1970).
14. The classification raises questions for research. Here is a list any of which might make a good dissertation topic: What sorts of dealings have depended historically on the existence of independent knower organizations? How much is a seal of approval worth to a promiser? Do trusters come to recognize credentials and seals of approval? Is competition among seals of approval desirable, or does it create bewildering cacophony? Do trumpeted seals of approval always signify satisfactory quality? Do seals of approval act as barriers to entry? Do knower organizations foster collusion? What leads members of the Better Business Bureau and similar organizations to join and cooperate? How do organizations that develop standards interface with the legal system? Do these organizations remain impartial? What

keeps them honest? Where information is based on past dealings, what damage is done to privacy? What can we learn from knower organizations about undercover tactics as a way to monitor and control behavior? What types of knower organizations tend to act as rent-seekers for their promiser-supporters (for example, the A.M.A.)? What types of organizations tend to act as rent-seekers, or mere political crusaders, for their truster-supporters (for example, consumer-interest lobbyists)? Will encryption and the Internet enable everyone to pursue detailed and interactive information paths about product safety while sitting at their personal computers?

15. '[T]he ban substantially increased the cost to firms of introducing new low-tar brands and the cost to consumers of obtaining information about these newer brands, thus slowing down the movement to these lower-tar cigarettes' (Schneider et al., 1981, 610).
16. BBB 1992 Annual report, p. 2.

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