How Firms Build Trust in Markets with Asymmetric Information

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Abstract: A nettlesome problem in some markets is that low trust often occurs between consumers and firms where product quality is difficult to discern. Akerlof (1970) suggested markets may cease to function altogether or only put “lemons” in markets such as used cars. Subsequent literature has explored solving this problem through reciprocity with multi-stage games, warranties, rating agencies, advertising, and sunk costs. However, this article’s contribution is to hypothesize that the deepest trust (and best reputation) is built by a firm sacrificing its short term profits in order to directly benefit the consumer, in a “lose-win” scenario with no reciprocity. The paper employs a simple heuristic model of a used car dealer faced with the costs and benefits of revealing to his customers hidden defects in his cars, over different time frames. Importantly, it is not initially clear whether firms will seek to build a reputation for honesty or “cut and run” with short run profits, if the firm’s time frame is unknown. What the model does do is frame marginal benefits and costs of taking each path, and explain how appropriate public policies can nudge firms towards investing in their reputation, brand and long term profits. In doing so, the need for regulations in these low-trust markets should diminish.
I. Introduction

Firms sometimes have enticements to place short term profits ahead of consumers’ best interests, in what has been called “opportunistic” behavior. This can occur under situations where the product’s quality is difficult to assess or where firms have little at stake in the long run. But Gordon Tullock (1985) concluded that the problem of opportunistic behavior was actually dispensed with by Adam Smith himself, through what Smith called the “discipline of continuous dealings.” Merchants will lose a valuable asset— their reputation—if they shortchange their customers.

However, Tullock neglects to mention another quote by Smith in his Lectures on Jurisprudence: “Where people seldom deal with one another, we find they are somewhat disposed to cheat, because they can gain more by a smart trick than they can lose by the injury which it does to their character” (cited in Shearmur and Klein 1987: 33). Shearmur and Klein also note that the logic of repeat dealings was “limited in scope” as far as Smith was concerned, although they proposed other ways to ascertain whether firms are trustworthy, such as voluntary institutions and personal interactions (ibid: 33).

When product quality is difficult to discern at the point of purchase, there is a tension in the marketplace between new firms seeking to build a reputation and customers who may be skeptical of the firms’ long term commitment towards them. An example might be a new tire company which advertises a tire life of 80,000 miles. If the tire fails at 40,000 miles, customers won’t find out for two to three years after the purchase. Consumers know there is an incentive for the firm to “cut and run” under some circumstances. So the firm faces convincing a skeptical public (and potentially government regulators) that it is committed to its customers for the long haul and will deliver a satisfactory product.

Building long term trust between firms and consumers in these circumstances is an old problem, and previous literature has explored various mechanisms for solving it using game theory, warranties, advertising, and sunk costs (as will be discussed later in the paper). However, this article’s contribution is to investigate an alternative avenue of building trust that may be deeper and longer lasting: New firms can publicly signal that they will sacrifice profits in the short run in order to directly serve their customers’ (and the firms’) long term interests. In other words, when faced with a “win-lose” or a “lose-win” scenario vis-a-vis consumers (say, spending money on quality or repairing a hard to spot defect) I hypothesize that the firm can build its reputation and brand by regarding the short term loss as an investment. The size of the sacrifice, I will argue, correlates to the firm’s long-run commitment to the consumers and the trust that is returned. An intuitive example is that a couple’s
trust in each other is more likely cemented not through mutual gift-giving during the holidays, but through each of them giving up something significant for the other at a particular point in time without direct reciprocity. A famous business case is Johnson and Johnson’s decision to remove millions of bottles of Tylenol in 1982 from retail shelves after seven people died from bottles laced with cyanide. The cost was more than $80 million but cemented a strong relationship with customers for years afterwards (Johnson and Philips 2003: 11).

This paper seeks to build a heuristic cost-benefit framework which illustrates the tension firms face between the short term profits and investing in its long run reputation and brand. The second aspect of the framework is to illustrate how its asset of reputation grows through the firm’s repeated short term sacrifices in short term profits. Using this framework helps illustrate where firms might be more likely to deceive customers, if their time frames are short. However, it also serves as a potentially valuable tool for policymakers to indicate that policies which steer firms towards longer time frames could substitute for regulatory initiatives which oversee firms’ day to day operations and potentially decrease their efficiency, profits and employment. I conclude that strong and trustworthy brands can substitute for regulation as: 1) public policies provide appropriate incentives (or avoid disincentives) for firms to invest in the long term, and 2) the firms signal they are doing so through visible short term sacrifices in profits that lead to better outcomes for their customers.

This has enormous implications, since the frequent rationale for government regulation is to ensure firms act in the best interest of consumers, especially where there is safety at stake. But this assumes a short time frame, and that firms always care more about immediate profits than building a reputation. And some indeed do, but if the firm’s time frame can in fact be influenced, then public policies which incentivize firms to lengthen their time frames will require less oversight, fewer regulations and less expenditure of public monies.

There are other good reasons to shift the current regulatory emphasis from oversight, discipline and punishment to incentivizing firms to look long term towards building trustworthy brands and reputation. First, regulators rarely (if ever) anticipate the next problem; their actions occur in reaction to it. A good example is the 2010 BP Gulf oil spill. The typical pattern began with a media alert to a product design failure, followed by public anger and outrage at the company, and then Congressional calls for new regulations. Second, agencies such as the FDA and the Securities and Exchange Commission (SEC) must then shoulder an enormous and complex job in designing and enforcing these regulations. During a “product quality crisis,” a government agency is often blamed for its lack of intensive investigation, but this is frequently inevitable where there are tens of thousands of products to
monitor. As Dudley (2011) notes, with hundreds of new regulations enacted each year, the job of enforcing them becomes increasingly expensive. Third, if we envision each regulation as a symbol of a new area of broken trust between the public, government and business, then each one also symbolizes further erosion in social capital. Like a neighborhood which experiences a single break-in and then builds a security gate and hires armed guards, regulations create enormous opportunity costs in terms of resources that must be siphoned away from productive uses such as investment and innovation, for monitoring and compliance. Various studies show a correlation between low social capital and relatively lower GDP growth rates, making this a growing concern (Fukuyama 1996; Knack and Keefer 1997). Fourth, Congress is much better at passing new laws than enforcing them. For example, the 2010 Dodd-Frank Wall Street reform law established that the SEC should regulate complex derivatives and asset-backed securities. It requires 387 rules from 20 different agencies, some of which “pit regulator against regulator” – and the SEC says the resources are too limited for it to do its job competently (Riley, 2011).

This paper proceeds as follows. First I provide a literature review of some of the more important articles written on the problems and remedies of asymmetric information, while indicating some shortfalls in the existing literature. Second, I examine the 18th century viewpoint and insights of Adam Smith in order to more fully understand the importance of brands today. Third, I construct a heuristic cost-benefit model of reputation building, using an example of defective used cars to delve into the question of whether and when the used car seller should be honest about the defect, even though it will cost him money. I choose this example deliberately, to construct an alternative model to Akerlof (1970) who suggested that consumers lose in these types of markets: They get the “lemons” more than the “cherries.” In contrast, I show that even unprincipled sellers will mimic honest ones if the time frame is right. In addition, I identify the key “switching point” in the sellers’ behavior that has important policy implications for regulators. Another example using a company selling inferior medical devices is also explored. Lastly I use the conclusions derived from the model to make some policy proposals that would help guide firms towards building reputations (and hence accountability with consumers) in an era where many consumers and regulators struggle with fathoming the complexities behind today’s products.

II. Literature Review

George Akerlof’s famous 1970 article on lemons in the used car market was intended to be an allegory about the problems inherent in a market where consumers have difficulty assessing product quality,
and firms care little about their reputation. Akerlof pointed out that used car dealers would have incentives not to reveal a low quality car to unsuspecting consumers, because they could make tidy profits as a result. To reveal product defects would only lower the price of the car. In addition, sellers of good-quality used cars would withhold them from the market, since he assumed buyers could only judge average quality but not individual product quality. As a result, sellers would not get their sought after price and they would withhold their good quality cars from the market. Akerlof’s conclusion, using these fairly strong assumptions, was that under these conditions markets would fail to develop.

His paper is one of the most cited in all of economics, probably because of its unsettling conclusion: it seems to upend the notion of Adam Smith’s invisible hand guiding self-interested buyers and sellers to mutual gains through trade. The paradoxical insight of the invisible hand depends on the free flow of information between the two parties—each knows what the other is offering in a market trade, and competition ensures that sellers please buyers. However, in Akerlof’s world, when sellers know more than buyers about the product for sale, they may suddenly flip towards advancing their interests at the expense of the buyer. Now the seller can pass along defects, inferior design, or other flaws to the buyer and make even more money. The invisible hand seems to have been transformed into an invisible claw.

With so much at stake, free market advocates replied to Akerlof’s article with many counter-arguments. Klein (1997) and O’Driscoll and Hoskins (2006) pointed out that when firms opportunistically scoop up short term profits by deceiving or shortchanging their customers, they risk harming their reputation—which is costly to acquire, easy to damage and the source of long term profits. That means leaving a profitable avenue for another firm to build its reputation on honesty, and would amount to “postulating that entrepreneurs leave money on the table” (ibid, 475). Klein (1997: 105) noted that “Our power to damage a (firm’s) reputation or to withdraw from dealings serves as a hostage that we hold against his promises.” At stake is not only accumulated value from past dealings, but also “the present discounted value of the gains from successive promise keeping” (O’Driscoll and Hopkins 2006: 474). (However, what is also at stake is the present discounted value of the gains from not keeping promises, as will be explicitly modeled later in the paper.)

Other companies can arise whose sole aim is to solve the asymmetric information problem, through independent certification. Brearly (1923) described how Underwriter’ Laboratories grew to a large non-profit company by certifying hundreds of electrical products as a “Symbol of Safety” with its “UL” trademark. De Long (1991) argues that J. P. Morgan Bank, with its sterling reputation, was able to provide assurance to investors in other companies, but putting a “Morgan man” on its board of directors. Richardson, Hall and Madjd-Sadjadi (2010) proposed using health information bureaus
(HIBs) as repositories for electronic medical records, using the model of credit bureaus. With three or more HIBs, each firm would have enormous incentives to reveal mistakes or risk losing their credibility in the marketplace.

In markets where product quality is difficult to discern, firm signaling is also a way to gain trust. Klein and Leffler (1981) created a model that shows how conspicuous sunk costs such as advertising and price premiums can assure customers of trustworthy, high quality products, because now the firm has committed its reputation to an even higher income stream. As a result, it has more at stake and more to lose by cheating the customer. Shapiro (1983) additionally concluded that a product price premium in these types of markets compensates sellers for their investment in reputation.

But what about the firms with a short term perspective? After all, take away the assumption of long term time frame, keep asymmetric information intact and all these models’ conclusions collapse since they depend upon a firm valuing (and even treasuring) the building of its reputation. Indeed, Posner (cited in Lynch et. al. (1986:8) points out two situations where “misrepresentation” of a product is substantial. First, if the product is costly or infrequently purchased and has an important characteristic that is not easily inspected; second, if the product, regardless of cost, has an important characteristic which “may remain hidden to the consumer throughout a long period of use. This is what he refers to as a “well-hidden characteristic.” Thus, both of these issues noted by Posner may result in market failure, e.g. misrepresentation if the firm’s time frame is shorter than the life of the product. Lynch (ibid:12) acknowledges that products with hidden characteristics are “surely more important for consumer protection policy,” but leaves these types of products aside in his analysis, choosing to study “experience goods,” or goods with repeat purchases in his study of how firms build reputation and value. But again, that assumes that firms always operate in the long run and ignores the impact that a firm’s time frame has on its decision to invest in its reputation versus misrepresenting its products and making more short term profits.

When the time frame changes it induces markedly different behavior on the part of the firm, as has been explored at length in game theory applications. For example, in one shot games the likely outcome is cheating, but as the time frame lengthens, cooperation and reciprocity become rational strategies (Hirschliefer 1999; Kreps et. al 1982; Tullock 1985; Axelrod and Dion 1988). However, the implications of how and why time frames could be changed is generally not discussed. For example, in an edited volume titled Trust by Khalil (2003), none of the thirty -six previously published (and mostly economics) journal articles on the subject discusses the reasoning behind a firm’s choice of time frame, and most ignore the question altogether. Rather than being fixed at “long run” or “short run,” the
firm’s time frame likely depends on the individual entrepreneur’s personality, age, personal discount rate, and cultural background, among other factors. Thus the distribution of firms’ time frames more likely resembles a bell curve of some kind.

III. A Heuristic Model for Reputation-Building in the Face of Asymmetric Information

The simple cost-benefit framework developed in this paper assumes the firm has a defective (or inferior) product it plans to sell, and this defect is unknown to consumers. The critical question it faces is: Does it plan to reveal or not reveal the product defect as a business strategy? A key point here is that each path has its own marginal costs and benefits, and the path chosen is dependent upon how long the firm plans to stay in business.

If the firm does not reveal defects as a profit maximizing strategy, then let us call the sales to consumers “adversarial transactions.” It is the land of “let the buyer beware,” since buyers will find themselves with products that are inferior or not performing as advertised, and regret the purchase when they discover this. If firms have a short-term time horizon, they have an incentive to deceive the customer (imagine a fly-by-night company) and make profits by selling these kind of products.

On the other hand, if the firm finds it profitable to reveal the product’s true limitations, then let us call this a mutually beneficial transaction. This is the land of the “invisible hand” that Adam Smith envisioned. Here, I mean buyers and sellers walk away, pleased with the transaction. There is no buyer’s remorse because all known defects or liabilities known to the seller were also made known to the buyer prior to the purchase. For a firm looking forward to the future, the net gains from each choice vary according to the time frame selected. This is what makes the time frame so critical to the analysis.

The model is based on a hypothesis: In a market where product quality is difficult to discern, when a dealer reveals a product defect he earns some trust and builds his reputation among future buyers. This is a way to communicate his commitment to the long term in the face of potentially skeptical buyers. The size of the short term sacrifice (i.e., investment) indicates the level of long-term commitment, and is directly correlated with reputation-building and the strengthening of the brand. The reputation of a firm can thus be seen as a stock of value that grows with short term investments on the part of the firm, and which yields long term returns. For the firm, the size of those reputational returns must be balanced against the losses of fixing the defect or improving the inferior product. As the firm’s
anticipated time frame of staying in business lengthens, those long term reputational returns grow ever larger, increasing the incentive to reveal the defect immediately. By doing so, one begins building a reputation. The decision upon which path to go is far from obvious, and is revealed below with an example. As we shall see, the choice of the time frame becomes critical in which direction the firm will go.

We might suppose that business ethics would also lead firms away from adversarial transactions. Adam Smith (1759) noted there were principles in human nature that served as a check on opportunistic behavior. He observed that “pity or compassion, the emotion we feel for the misery of others, when we either see it” served an important role. But while Smith wrote as if sympathy were a fixed principle of human nature, various psychological studies have shown that people range in their sensitivity towards others’ feelings. For example, Davis (1983) found in a study of 677 males and 667 females that empathy has multiple dimensions; he used an index to measure the ranges in sensitivity towards others. The point here is that evidence is strong that humans range from very high to very low levels of “fellow-feeling” as Smith (1759) called it. In other words, consumers shouldn’t be surprised if they get taken advantage of by some individuals despite the moral check of “sympathy” as posited by Smith. Indeed, this is the frequent characterization of business people in films, where plots hinge on the firm making profits at the customer’s expense (Ribstein 2005). Ribstein (2005) argues that these films have a persuasive power that “tips the political balance towards regulation.”

In the simple model developed below, I assume the caricature of a homo economicus who maximizes profits without a conscience. In addition, in another nod to assumptions made by market critics, I assume acquiring information on the product is difficult and/or extremely costly, but that like the Akerlof “lemons” model, the expected value is known, which includes the possibility of purchasing a product with an unknown defect. I also assume high barriers to entry and that consumers do not relay information to each other about defective products. In other words, the traditional disciplinary actions of the market- informed consumers, owners with a “Smithian” sense of moral sympathy and strong competition- have been eliminated.

These strong assumptions serve to darken the lines of the outer bounds of what might go wrong. By assuming the worst, we can observe the worst possible outcome. It also creates clarity in the model by dispensing with the problem of how to measure the impact of business ethics in firm’s decision-making process. I aim to illustrate, using a heuristic model based upon the above considerations, that there are still long-term incentives for the firm to behave in a way that will emulate ethical, loyal and transparent business behavior towards consumers, even if markets are less than competitive. It also implies that
government policies that incentivize firms towards looking to the long run will create a lower necessity for government resources to be spent enforcing regulations. Instead, brand power and reputation can serve as a viable substitute and even build trust between businesses and government regulators or consumers. The following uses the case of used cars, which typically have some aspects of product quality that are difficult to evaluate. Like Akerlof’s model, the used car market is picked for its usefulness as a pedagogical example rather than its realism.

**Example: The case of Flow Motors**

Used cars represent a step into the unknown for car buyers, who may not know the car’s repair history or particulars of past ownership. As a result, buyers price this risk into their willingness to pay for used cars, which decreases the expected value, and therefore the selling price, for a given car. Let us call the buyer’s expected value of the used car with potentially hidden defects, E(C\text{Hide}). Although used cars will have a distribution of potential undisclosed problems, let us suppose for purposes of illustration that a given firm sells one type of car per time period with a defect hidden from buyers that costs F dollars to fix. Its expected time frame to stay in business is equal to n time periods.

If the firm, say Flow Motors, has a company policy that preemptively and voluntarily fixes these defects (letting the customer know of this), then correspondingly its community-wide reputation for honesty increases over time, and the used car is more valuable to consumers as a result. Lower risk translates into higher expected value and higher market prices. Flow’s reputation is expected to increase at a decreasing rate, in line with the law of diminishing returns. Put another way, risk will not drop to zero over time, but approach a new lower bound for firms with an excellent reputation. After all, there may be companies with sterling reputations but no guarantee is 100 percent credible. A real-life example of this is the company CarMax, which has built a reputation for its rigorous inspection and reconditioning of used cars along with money-back guarantees. As a result, its prices tend to be higher than competing car dealerships (PRNewswire 2011).

But Flow may debate to itself whether or not to have an “honesty policy” since fixing the defects also lowers its short term profits. If, for example, the owner has plans to sell the business in the next year, the future gains from reputation may not offset the current repair costs. The below equation illustrates Flow’s choice as a decision at the margin, in terms of the total present discounted value of revealing defects minus the total present discounted value of hiding them. The issue for the firm is whether the change in profits will be negative or positive as a result of revealing defects. (I ignore the acquisition
cost of the vehicle here for simplicity.)

\[
\Delta \pi = \sum_{i=1}^{n} \frac{E(\text{C}_{\text{Hide}i}) - F_i + \text{REP}_i(F)}{(1+r)^i} - \sum_{i=1}^{n} \frac{E(\text{C}_{\text{Hide}i})}{(1+r)^i}
\]

Where:

\( \Delta \pi \) = the present discounted value of the change in profits between revealing and not revealing defects after \( n \) periods,

\( E(\text{C}_{\text{Hide}i}) \) = the expected selling price of a given used car, \( C_i \), if a dealer does not reveal defects as a matter of firm policy, based on consumers’ expected average cost of fixing a hidden defect after the sale,

\( r \) = the discount rate,

\( F_i \) = the dealer cost of fixing the automobile’s defect (assumed to be the same in each time period),

\( \text{REP}_i(F_i) \) = an investment function in which the reputational value of the dealer is added to a car’s former price, \( E(\text{C}_{\text{Hide}i}) \), boosting a customer’s willingness to pay, and assuming it increases at a decreasing rate as both \( F \) and time increases; in addition, for simplicity, I assume no changes occur to reputation if defects are not revealed),

\( n \) = number of time periods a seller expects to stay in business, and

\( i \) = the \( i \)th time period.

Now set \( E_i(C_{\text{Reveal}}) = E_i(C_{\text{Hide}i}) - F_i + \text{REP}_i(F_i) \), the denominator in the first term above, where \( E_i(C_{\text{Reveal}}) \) = the expected revenue to the dealer after revealing defect in period \( i \). This takes into account both the marginal cost of fixing the defect and the marginal revenue from the dealer’s increased reputation (boosting the consumer’s willingness to pay).

Equation (1) can be rewritten as (1’) below:

\[
\Delta \pi = \sum_{i=1}^{n} \frac{E_i(C_{\text{Reveal}})}{(1+r)^i} - \frac{E_i(C_{\text{Hide}i})}{(1+r)^i}
\]
Alternatively, equation (1') can be rewritten as below, since both E(C_{\text{Hide}}) terms drop out upon simplification, which makes the marginal benefit-marginal cost decision to reveal defects more clear:

\[
\Delta \pi = \sum_{i=1}^{n} \frac{f(\text{REP}_{i}) - F_{i}}{(1+r)^{i}}
\]  

When \( \Delta \pi \) is < 0, the firm faces opportunity costs to revealing the truth equal to \((-)\Delta \pi\) and will have an incentive to not reveal the defect, as company policy. (Unmeasured ethical or “sympathetic” tendencies on the part of the dealer may overcome this opportunity cost if it is low enough). As the time frame increases and \( n \) grows larger, the value of reputation increases (at a decreasing rate) and lowers the opportunity cost of telling the truth about the defect. In equation (1), when the first term equals the second, the firm is indifferent between revealing and not revealing defects. However, when the firm anticipates staying in business just a little longer, \( \Delta \pi \) becomes > 0, and Flow’s company policy suddenly switches to revealing defects on all its vehicles. The equation also shows some other insights. As the cost of fixing the defect (F) grows, it implies that the firm may have fewer incentives to reveal defects, since the net gains will get smaller or even become negative. Potentially, the benefits from reputation could never offset the cost of fixing the defect.

Figure 1 shows this concept of returns to reputation more generally. Assume a used car costs $5,000, and the defect costs $500 to fix. One car is assumed sold per time period. The horizontal gap between TR (not reveal) and TR (reveal) shows the cumulative opportunity costs the firm faces by revealing the product defect, and is measured by distance “A.” The distance denoted “B” is the cumulative value added to the cars as the perceived reputation of the seller grows. The intersection point “X” (where A = B) is the break-even point for revealing defects. If a firm expects at time period zero to stay in business past the break-even point, even an ethically challenged firm will act as if it were ethical, and reveal defects as firm policy from the beginning (at time = 0). At this point, the cost of fixing 6 cars * $500 = $3,000, so the firm makes only $27,000 in revenue instead of $30,000, if reputation were not considered. However, the growing value of the firm’s reputation boosts the amount it can charge for each car (TR reveal + reputation), so at “X” this total value reaches $3,000, just offsetting the repair costs. Thus, a firm’s willingness to bear large costs when defects are discovered reveals the time frame of the firm and its commitment to its customers. The firm’s anticipated time...
Figure 1. Returns to Reputation

If a firm anticipates a time horizon of 6 or more, it reveals defects on all its products at time = 0.

Defects not revealed if time frame is < 6 periods.

Anticipated time horizon
frame thus becomes a crucial variable in this model that dictates dramatic current changes on the part of the firm once “X” is passed.

IV. Policy implications

However, the time frame for a firm, n, is not a constant but is itself a function of many factors, including the personal discount rate of the firm’s owner, tax policies that affect the time frame of investment, and intellectual property rights such as patent and copyright laws. Therefore, if a firm’s time frame is less than X, as shown in Figure 1, its company policy will be to hide all defects for its units sold. But if government policies encourage the firm to expand its time frame to say, some period greater than X, this will cause the firm to reveal and fix the defect as company policy. An alternative policy could focus on lowering the cost of fixing the defect, F, by say, allowing more generous cost write-offs in these circumstances. Here, firms would need less regulation and become more likely to use their own resources to correct product defects in advance, (although conceivably moral hazard problems could arise). In this case, the TR (reveal) and TR (reveal + reputation) curves would shift up by the same amount, bringing the break-even point X closer to the present. This would mean an increased probability of the firm revealing and fixing defects on its own rather than being forced to do so.

Market solutions could also cause positive upward changes in the TR(reveal + reputation) curve. A firm that “does the right thing” in revealing and fixing defects could be rated by a private agency using online customer reviews or paid reviewers, leading to an increase in steepness of the curve. The reputation of the rating company would be developed in the same way as the auto dealership, by avoiding conflict of interest positions which might increase short term profits, such as being paid by the dealerships. Higher ratings would signify increased returns to auto dealership for investment in reputation-building. The firm’s break-even point would come closer to the present, and increase the probability of a given firm changing its company policy such that it reveals defects. As a result, societal resources could be used for alternate and more highly valued uses than increased regulation of these markets.

Example 2: Another application: Medical devices

As discussed in the literature review, Posner outlined special cases where products with “hidden characteristics” might lead to market failure due to severe information asymmetry. Let us now
take another concrete example which might entail a deeper threat to consumer safety and welfare. Suppose there is a case where a heart pacemaker has been developed, with a multi-million dollar investment on the part of the firm, MedPace. It turns out that after extensive testing, the firm’s lab discovers the pacemaker’s expected life is only 10 years. Yet it has obtained investor funding based on its former projections of an expected life of 15 years. Medical providers are lined up to buy the product. What does it do? Does it reveal the results of the testing and see a big loss for what it can charge? Or does it deal with the problem ten years down the road, when it may not even be in business? In these type of cases, it may be naïve to depend on the seller’s ethical foundation. For example, single use medical devices are increasingly being used again to save costs, despite some evidence that patient health may suffer (Landro 2008).

Let us assume MedPace is initially situated in the “adversarial zone,” which is in a time period between 0 and “X” in Figure 1. With this time horizon, the revenues from not revealing the defect exceed the revenues from revealing it. This looks like a clear-cut case for regulation or greater government oversight of this industry. Given their prospective time in the market, the firm’s strategy would be to not reveal the defect in the medical device and harm consumers. But policy makers might examine further options that would guide firms such as MedPace to mutually beneficial transactions.

For example, one might ask what incentives MedPace (and indeed all companies selling products with hidden characteristics) could be given such that its time horizon moves to the right—hopefully into the “mutually beneficial” zone past point X. The idea is to have policies which guide firms with complex and difficult products into considering the long term as their frame of reference. This lowers the probability that they will hide defects and instead think about burnishing their reputation with reputable products.

V. Other trust deficits addressed through branding

Bernauer and Caduff (2006: 88) note that firms address “trust deficits” in the marketplace through branding which they call the “privatization of consumer trust.” (Their ideas relate to the food industry but are generalizable to the market.) Consumers reward them for this because they see firms as more accountable for their actions. Branding accomplishes two things: it shields firms from safety problems caused by other firms, and may even increase market share. On the other hand, firms are more accountable when there are safety issues with their brand, as it can’t
be externalized to the entire market. In a market where customers may perceive the product as unsafe, firms have an incentive to gain market share by branding their product and assuring customers that this accountability will make their products safer than others. By adopting a brand, the company actually increases its risk if it moves from individual brand products to an association with the entire firm as a brand. (ibid: 89). If there is a faulty product in just one product line, the entire brand risks damage and a corresponding stock devaluation. But the upside is that a widely admired brand creates enormous trust on the part of the consumer faced with an array of different products, and allows the company to increase its market share.

Firms’ use of brands also may lead them to adopt higher safety standards than are required by government set-standards. By adopting tougher standards, they gain trust with government regulators and even buy political legitimacy and goodwill.

Low trust-low value relationships are “doomed” according to Singh (2005:41). His analysis sees firm’s decisions as a “trust-value tradeoff” which is another way of saying a firm can invest in its long-term reputation by building trust, but this may cost it “value” or short-term profits. In this framework, building “trust” through positive branding is a way to maximize long-run profits, whereas choosing “value” is really just another way of describing a focus on short-term profits with less accounting for long run harm towards the firm’s brand and its customers.

VI. Conclusion and Policy Implications

This paper has shown that in some cases there is a tension within a firm between revealing and not revealing defects in hard to evaluate products. In those cases, some may see regulation as the vital corrective. However, as discussed in the beginning of the paper, the vast number of complicated goods- from medical devices to financial products- makes it nearly impossible to monitor all products’ safety. This model of reputation and brand building shows that firms can communicate their long term commitment to consumers by sacrificing short term profits in order to deliver high quality products. This short term investment in reputation indicates by its size the likely length of time the firm plans to stay in business. Since over time nearly all products can be evaluated, a firm with a longer time frame is more likely to produce quality products. This is not to suggest that branding can in all places and times replace regulation, but to show that potential trouble spots can be dampened or even solved through policies that nudge more firms to be invested in the long run.
This paper has implications for tax policies, intellectual property rights and other government policies that currently steer firms towards short term thinking. Lowering capital gains taxes will make long term investments in building reputation relatively more attractive. Policies that expand intellectual property rights and protect firms from counterfeit reproductions produced overseas will give incentives for producers to think about the long run. Another idea could be to end accelerated depreciation of capital- which encourages the firm’s short term planning and may lead to more “cut and run” behaviors. By changing those types of policies and lengthening firms’ time frames, even so-called unethical entrepreneurs will find that in order to maximize profits, they will be far more likely to serve their customers in mutually beneficial ways, lessening the expenditures needed to both enact and enforce new regulations on business. Thus, there can be a “win-win-win” outcome for firms, consumers and taxpayers in the long run.
References


