

- Information, Market Failure, and the Role of Government

## The Importance of Reputation and Standardization

Asymmetric information is also present in many other markets. Here are just a few examples:

- **Retail stores:** Will the store repair or allow you to return a defective product? The store knows more about its policy than you do.
- **Dealers of rare stamps, coins, books, and paintings:** Are the items real or counterfeit? The dealer knows much more about their authenticity than you do.
- **Roofers, plumbers, and electricians:** When a roofer repairs or renovates the roof of your house, do you climb up to check the quality of the work?
- **Restaurants:** How often do you go into the kitchen to check if the chef is using fresh ingredients and obeying health laws?

In all these cases, the seller knows much more about the quality of the product than the buyer does. Unless sellers can provide information about quality to buyers, low-quality goods and services will drive out high-quality ones, and there will be market failure. Sellers of high-quality goods and services, therefore, have a big incentive to convince consumers that their quality is indeed high. In the examples cited above, this task is performed largely by *reputation*. You shop at a particular store because it has a reputation for servicing its products; you hire particular roofers or plumbers because they have reputations for doing good work; you go to a particular restaurant because it has a reputation for using fresh ingredients and nobody you know has become sick after eating there. Amazon and other online vendors use another model to maintain their reputation. They allow customers to rate and comment on products. The rating and commenting feature reduces the lemons problem by giving customers more information and motivating vendors to uphold their end of the bargain.

Sometimes, however, it is impossible for a business to develop a reputation. For example, because most of the customers of highway diners or motels go there only once or infrequently, the businesses have no opportunity to develop reputations. How, then, can they deal with the lemons problem? One way is *standardization*. In your hometown, you may not prefer to eat regularly at McDonald's. But a McDonald's may look more attractive when you are driving along a highway and want to stop for lunch. Why? Because McDonald's provides a standardized product: The same ingredients are used and the same food is served in every McDonald's anywhere in the country. Who knows? Joe's Diner might serve better food, but at least you *know* exactly what you will be buying at McDonald's.