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How Markets Produce Trust

by Daniel B. Klein

Suppose the muffler drops off your car in the middle of Iowa. You pull off the interstate and find Joe's Auto Repair. The mechanics at Joe's see that you are from out of state. They know that, regardless of how fairly they treat you, you will not be returning and will not be speaking to other potential customers. Hence, caution is advised. Then you notice a Meineke shop down the road. You will never be returning to that Meineke shop either, but for some reason you have more trust in Meineke.

Although you will never return to that particular Meineke shop, you might reach a judgment about Meineke shops in general on the basis of your experience at that shop. The franchisee at that shop doesn't care whether you ever go to another Meineke shop, but the parent company does. The parent company wants that franchisee to treat you fairly, and it takes steps to make that happen. Meineke employs "mystery shoppers" who pose as ordinary consumers with broken cars. Also, the parent company receives and remedies customer complaints. Consumers might not be consciously aware of such trust-building practices, but they rightly intuit that some kind of assurance lies in familiarity. The company name is a bit like a friend, and the serviceman wearing the company logo is like the friend of a friend. He is not your bridge to Meineke; Meineke is your bridge to him.

As we all know from our personal experience, consumers seek trust. What is less obvious is that entrepreneurs endeavor to supply it. Meineke is at the interstate exit precisely because there is a trust problem to be solved, and profit to be had in solving it. The franchise relationship is just one trust-building practice. Consumers demand not only quality and safety; they demand quality and safety *assurance*. They demand trustworthiness. Entrepreneurs, who find profit in meeting that demand, have developed a vast array of practices and institutions for doing so.

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Americans now endure a large number of governmental restrictions that are justified on the grounds that free, voluntary practices are not able to overcome adequately the problems of low-quality or unsafe products and services. The Food and Drug Administration restricts freedom of choice in pharmaceuticals; the Occupational Safety and Health Administration restricts freedom of contract in regard to workplace conditions; occupational licensing restricts the freedom to enter a trade; and so on. Economists have shown that those restrictions impose heavy costs on society. The FDA causes thousands of premature deaths every year, and occupational licensing raises the cost of services. If regulations lead to enhanced quality and safety, then the costs may be outweighed by the concomitant benefits. But if such benefits would have been achieved anyway by voluntary institutions, then there really are no benefits to balance against the costs.

Trusters and Promisors

The *truster* (referred to by feminine pronouns) may be the customer of a doctor, an auto mechanic, an accountant, a lawyer, or a securities broker. She may also be a landlord, a creditor, an employee at a potentially hazardous manufacturing plant, or an employer enrolling her workforce in a health-care organization. She must decide whether to entrust her resources to the *promisor* (referred to by masculine pronouns). Does the promisor have the incentive or inclination to honor

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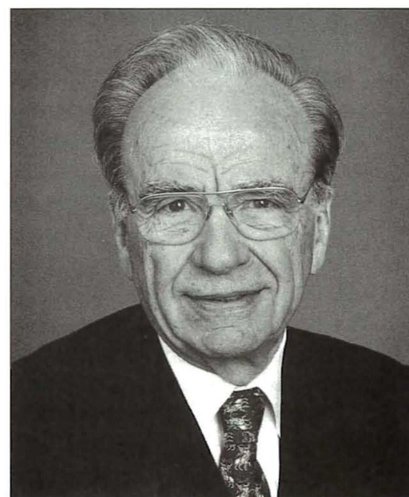

Rupert Murdoch, chairman of News Corp., has joined the Cato Institute's Board of Directors. Story on page 15.

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“Consumers seek trust. Entrepreneurs have developed a vast array of practices and institutions to supply it.”

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her trust?

One way to alter the structure of interaction so as to lessen the dependence on trust is for the truster to keep some advantage until satisfaction is complete. An elementary solution is simply to have the promisor—whether he be a building contractor, a taxicab driver, or a lawyer—provide the service first and bill the truster afterward. A tenant, in the role of promisor, gives a security deposit to the landlord. In the case of products and services, manufacturers and practitioners can offer guarantees and warranties. Finally, there is the tort system.

Remaining in business for a prolonged time gives rise to the businessman's reputation—that is, the general opinion of his trustworthiness. Continuity and repetition are fertile ground for trust. In a sense, one's power to damage a promisor's reputation or to withdraw from dealing with him serves to hold him to his promises. Promisors build and protect their reputations, knowing that “time wounds all heels.”

Reputational Nexus and the Middleman

In every area of life—the family, the church, the social club, the neighborhood, the workplace, the marketplace—we find a network of extended dealings, or a *reputational nexus.* Sociologists figure that any pair of adult Americans can be linked by three or fewer intermediary acquaintances.

Businesses can make a profit from providing reputational networks. The livelihood of the middleman often depends on creating a bridge of trust between two traders.

The Meineke Company, the franchisor, provides a reputational bridge between the motorist and the franchisee, who meet only in passing. Franchised motels, restaurants, and convenience stores also profit from trust based on infrequent dealings with many customers.

The role of the reputational bridge is best demonstrated by the retailer, who, a hundred times daily, serves as the link between a consumer and a producer. Many of the matches between consumers and producers are infrequent—for example, a consumer's purchase of a washing machine or an ulcer medication—but the consumer has extended dealings with the retailer, who in turn has extended dealings with the producer. By carrying the appropriate array of products, middlemen can make a profit by creating trust in the consumer who has an occasional need of a specialized commodity.

Besides straddling two distinct extended relationships, the middleman also acts as a knower—by recognizing brand names and seals of approval, by conducting his own tests and inspections, by keeping track of customer complaints and purchase returns, by hiring testing services, by following trade literature or consumer literature, by studying whether other retailers carry the product, and so on.

In his role as knower, the middleman specializes in an information service that is often too costly for the consumer to provide for herself. In a sense, the premium she pays to the middleman, whether he be an established retailer, a brand-name manufacturer, or a contracting organization like a health maintenance organization, is a fee for the luxury of being both uninformed and assured of quality.

The information service provided by retailers is welcomed also by manufacturers of good products, who depend on the services and institutions that permit the goodness of their products to be recognized. By creating trust, effective retailers and middlemen sell more of the product at higher prices.

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 many unstandardized goods and unfamiliar marketing techniques. Consumers had difficulty judging the freshness of foods or the durability of clothing. The consumer historian Norman Silber tells how the market responded:

> 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.

A brand name is a way of gathering together an array of services that make for frequent dealings. A machine-tool company like Black & Decker may market 30 different products, but its customers will make generalizations about all 30 on the basis of experience with only a few. 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 that way, Black & Decker becomes an institution providing the essential service of trust. The inventor-genius may create a fantastic new tool in his basement workshop, but he cannot create trust in his workshop. Trust emerges only as institutions age and markets adapt. The genius in his basement has created a great invention, but he has not produced a great *product.* To achieve the latter he must collaborate with those who have achieved trust; he will 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 knower that tells the truster that the inventer's new gizmo is trustworthy. Black & Decker is not only a manufacturer and distributor; it is also a knower organization granting its own seal of approval.

Information for Sale

Trusters dislike being cheated. They will pay good money for information that protects them. The provision of information itself becomes a source of profit.

Information provision can be divided into two stages: generation and conveyance. The generation of information can take the form of testing, inspecting, researching, evaluating, or interpreting. For example, Consumers Union does all of those things when generating product ratings to be published in *Consumer Reports.* CU makes profits by selling its magazine to trusters. Is its information a “public good”? No, because the information is proprietary, and to a large extent excludable. CU sues companies that use its ratings in advertisements, as well others who appropriate and pass on its information.

Once a person has the CU ratings, she can indeed share them with her friends and acquaintances—she may even sell her exper-

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tise in some manner. But she is prevented by law from reproducing the information and selling it. If you can protect information at the conveyance stage, then you can appropriate its value at the generation stage.

In the case of *Consumer Reports,* excludability is achieved in large measure by legal sanctions. But excludability is often simply a matter of technical limitations on the part of would-be free riders. Information conveyance requires information receiving, organization, storing, retrieval, and transmission. For example, credit bureaus like Equifax sell credit reports to trusters. They make profits by facilitating dealing, just as Manhattan parking entrepreneurs make profits by facilitating dealing. Equifax releases valuable information to millions of parties every month, but that does not mean that those parties can appropriate the value of the information by reselling it to others. Besides proprietary constraints, there is the fact that Equifax is providing highly individualized information. Its strength is in making information complete, timely, and accurate. For someone to free ride on Equifax, she would have to invest in vast data-processing systems.

Information, No Charge: Self-Disclosure by Promisors

Promisors also may be keenly interested in hiring knowers to generate information about them and to convey that information as widely and freely as possible. Sellers employ salespeople to demonstrate and describe the product, they set up displays, they advertise product characteristics, they recruit the services of referral agencies, they offer guarantees and warranties.

But can the information be trusted? Marketing claims of “New and Improved” give cause for suspicion. Promisors often mislead and deceive trusters. But trusters know their vulnerability and look for solid evidence. In consequence, promisors who can give evidence of trustworthiness are rewarded in business traffic.

One sort of evidence is demonstration of traits that are indicative of trustworthiness, such as announcing, “Established in 1924,” or engaging in a heavy promotional campaign that would be lucrative only for a worthy promise. Thus consumers make inferences, if only subconsciously, from the life of the firm, the size of the firm, and the extent of advertising.

Another sort of evidence is the word of an independent knower, someone who can evaluate the product but who does not reap gains from its success. If the word is favorable, the promisor will spread it far and wide.

It is good fortune to win an award or be praised by the critics. But sometimes promisors do not wait around for fortune to find them. They simply hire a knower to make an evaluation. The knower is remunerated for generating the information, and, if the word is favorable, the promisor invests in conveying it to trusters. For example, 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 the rating is then used in marketing the securities. Another class of independent knower organizations remunerated by promisors is made up of professional schools, technical schools, and institutes that grant degrees and certificates. Those credentials are then prominently displayed on office walls and listed in curricula vitae. Transcripts and academic honors give a sort of rating system to the degrees. Each of those organizations grants its own seal of approval.

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 promisors. Using the two distinctions, we get the classification scheme shown in the figure.

The left-hand column of the figure shows knower organizations that are remunerated by trusters. Those that generate highly individualized information, like hired inspectors and people who give second opinions, do not face free-rider problems simply because the information buyer cannot hope that someone else will pay to have the pertinent information generated. Knowers that generate information about standardized products, of interest to many trusters, generally make

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Classification of Knower Services

Knower Engages in Information	Knower Is Remunerated by: *Trusters*	*Promisors*
Generation	Hired inspectors (UL inspection service) Second opinions	Certificates, seals of approval (UL mark) Credential givers Bond ratings Letters of recommendation Financial and accounting audits
Generation and Conveyance	*Consumer Reports* Dun & Bradstreet information service Industry newsletters Hobby, product, and news publications Restaurant and movie reviews Employment agencies	Better Business Bureau Medical data banks Employment agencies
Conveyance	Gossip Consumer credit bureaus	Referral services Advertising firms

"Replace the FCC with common law"

Is the Telecom Act of 1996 a Failure?

"The telecosm is too large, too heterogeneous, too turbulent, too creatively chaotic to be governed wholesale, from the top down," said Peter Huber at a September 12th Cato Institute conference, "Beyond the Telecommunications Act of 1996: The Future of Deregulation." Huber, senior fellow at the Manhattan Institute and author of *Orwell's Revenge*, and Tom Hazlett, professor of economics at the University of California at Davis, maintained that the Federal Communications Commission should be eliminated and regulation of the telecosm left to common law.

Solveig Singleton, director of information studies at Cato, went one step further and considered what the telecom industry would look like had the FCC never been created and the industry never been regulated. She conceded that it is likely that the industry would be highly concentrated but argued that concentration is not necessarily a bad thing. "When you look at many concentrated markets, such as the computer industry, consumers are doing quite well. We need to change our focus on what telecom competition should look like. Despite Reed Hundt's claims, it will never look like and will never have as many entrants as the market for shoes."

In his luncheon address, "Resisting the Temptation to Micromanage Deregulation: Lessons from Airline and Trucking Deregulation," Alfred Kahn, former chairman of the Civil Aeronautics Board, maintained that regulation is needed "to protect captive consumers and to provide equal access to essential facilities." But, he said, the FCC has done much more than that. "They have engaged in inexcusably gross handicapping of the competitive process. They have cartelized the industry and protected inefficient competitors from well-deserved extinction."

Broadcasting pioneer Stanley Hubbard talks with Cato's Tom W. Bell as legendary deregulator Alfred E. Kahn goes over his speech notes at Cato's conference on the Telecommunications Act of 1996.

Evan Kwerel and John Williams of the FCC conceded that their agency has done much to prevent the efficient use of spectrum. In addition to retaining large amounts of spectrum, the government has too narrowly circumscribed the manner in which privately managed bands can be used. "An essential step toward an efficient market allocation process," said Kwerel, "is to exclusively assign all or virtually all spectrum rights. These rights include all uses at all points in time, frequencies, and geographic locations."

Broadcasting pioneer Stanley Hubbard agreed with Kwerel and Williams, stating, "Broadcasters should be free to do whatever they wish within the confines of the general laws of the land." He argued that "those individuals and companies that pioneered and own radio and television stations should have clear title to their licenses just as if the licenses were land grants."

With the growth of the Internet, many people have argued that government should provide everyone free access to the Web, much like it provides a high school education. Lawrence Gasman, senior fellow at the Cato Institute, challenged that idea. He maintained that the "real reason why government programs for helping information have-nots enjoy so much support is not because those programs make any economic or moral sense but because they are politically profitable. Leftish Democrats can be seen as doing something for the poor, while conservative Republicans can be seen as doing something for their rural constituents."

The papers presented at the conference will be published as a book next year. ■

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money from conveying the information, and to do so they must enjoy a measure of exclusion. Their information may be protected by law (e.g., *Consumer Reports* ratings, any type of copyrighted review) or difficult to reconvey (e.g., credit reports, gossip). The right-hand column shows knower organizations that are remunerated by promisors. Promisors may pay them for generating a seal of approval (certifiers, inspectors, credential givers), for conveying information (referral agencies, advertising firms), or for both (information bureaus).

Trustworthy promisors have every incentive to self-disclose, and they employ a wide variety of means to do so. What about the untrustworthy? They 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 make inferences from the dog that didn't bark: the missing accolades, seals of approval, and endorsements. When we view a curriculum vitae, a lack of distinctions will make itself evident and lead us to doubt outstanding talent. Similarly, trusters remain wary of a restaurant with no posted reviews, an appliance without a UL mark, or a mechanic without a company name.

Another way to apprehend untrustworthiness is, of course, through the knower services remunerated by trusters. Hired inspectors, *Consumer Reports*, Dun & Bradstreet, Equifax, Siskel & Ebert, and the neighborhood gossip all report on the trustworthy and untrustworthy alike.

Concluding Remarks

When consumers demand toothpaste, that demand creates opportunities for entrepreneurs to profit by providing toothpaste. When individuals demand trust, that creates opportunities to profit by providing trust. Voluntary institutions—including knower organizations, firms, market forms, and social networks—evolve, not merely to provide quality and safety, but to provide quality and safety *assurance*. The desire for profit causes firms to develop brand names, networks, and other institutions that can supply reliability, which then generates a greater degree of trust. Voluntary cooperation in civil society can generate reliability and trust without coercive government regulation and the bad consequences that such regulation often generates. ■