

Economics of Reputational Information

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This paper looks at the supply, demand and regulation of reputational information. I define “reputational information” as information about an individual or company’s past performance that helps a decision-maker predict the individual or company’s future performance.

Reputational information plays a critical role in marketplaces because it can help reward good producers and punish poor performers. As a result, any defect in the supply or demand of reputational information can seriously distort the marketplace generally.

My first observation is that consumers know lots of valuable reputational information but that information does not help other consumers make marketplace decisions so long as it remains private information. Consumers do “communicate” their views through their marketplace decisions (such as continuing as a repeat customer, or switching to a new option), but each individual consumer’s decision is often not readily observable by other consumers, and the rationales for consumer decision-making (such as why the consumer chose one product or competitor over others) is rarely publicly available either. The marketplace mechanism might improve with better supply of this private information.

My second observation is that many reputational systems exist, but they are regulated quite differently. For example, compare credit scores, where both supply and demand are heavily regulated, with recommendation letters, which are virtually unregulated. This heterogeneity of regulatory structures for reputational systems raises some questions. Why the differences? Can we use our experiences with one reputational system to craft better regulations of other reputational systems?

Expanding on these two observations, this paper will have four parts.

The first part will inventory the various types of reputational systems and describe their similarities and differences.

The second part will consider supply factors of reputational information, including how financial incentives can stimulate production, how disincentives (such as the threat of legal action for providing negative comments) may suppress supply, the credibility of reputational information (including pay-for-play and how supplying reputational information affect the supplier’s reputation), the role of intermediaries and the role of anonymity.

The third part will consider demand factors of reputational information, including credibility concerns of consumers of reputational information (and how consumers reduce transaction costs by “outsourcing” reputational assessments), privacy concerns and the potential for consumers to misinterpret aggregated reputational information.

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The final part will develop policy guidelines for regulatory intervention into the supply and demand of reputational information. This part will conclude by identifying situations where the heterogeneity of current regulatory structures might be suboptimal.