

Is Reputation Good or Bad? An Experiment

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Many people (and institutions) are concerned about their reputations. Reputation usually consists of past choices that are observable to others. The ability to build a reputation in repeated interactions and its importance has been studied in economics for quite a while and gotten a breakthrough in the early 1980s. The main finding is that economic transactions between total strangers are facilitated because of the availability of information about past behavior. The importance of this market enhancing effect of reputation is apparent to anyone who shops on the internet gathering information on the reputability of various vendors before providing credit card details.

Recently, however, it was theoretically discovered that reputation can perversely affect market outcomes. This may happen especially in markets where the service provider also has to provide a diagnosis of the service required. An example of this could be a mechanic who also has to diagnose what ails the automobile or a dentist who has to diagnose the painful tooth. Roughly speaking, the bad reputation result arises because a mechanic who is being asked on recommendations for a series of cars that all need an engine replacement might suggest a less drastic repair because of the fear that future motorists will prefer going to a mechanic with a “better” record that doesn’t charge an arm and a leg each time. The incorrect repair that the mechanic does to build a reputation of being a good mechanic harms the current motorist who will need another repair soon. Therefore, if even honest mechanics have an incentive to do something inappropriate these markets are predicted to never make it.

In this paper we experimentally investigate the effects of reputation in markets that are predicted to benefit from it as well as in markets that are predicted to be harmed. In fact, our experimental design nests a model of good reputation with that of bad reputation. We contrast behavior in these frameworks with one another as well as to situations when there is no chance for reputation building because no information about past behavior is being made public. We have found that the possibility of reputation building is not as detrimental as is predicted by the “bad reputation theory,” however, it is also not necessarily as good as predicted by the “good reputation theory.” We propose trust to be the major component of why observed behavior deviates from theoretical predictions, and suggest trust to be a substitute for reputation.