

EconWorld2014@Prague

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# From Lemon Markets to Managed Markets: The Evolution of Ebay's Reputation System

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## ABSTRACT

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The absence of perfectly symmetric information potentially leads to adverse selection, market inefficiencies, and possibly market failure. To mitigate these problems, market designers rely on different policies. Some adopt reputation policies, in which they certify high-quality users and help them signal their quality; others provide marketplace warranty policies to prevent low-quality users from participating. We have a unique opportunity to investigate the interaction of these two policies and the possible efficiency gains in light of the introduction of the eBay Buyer Protection program. We first demonstrate eBay's reputation system raises the average sales price and the fraction of successful sales for certified sellers by 4% and 3%, respectively; this result is robust for various specifications. Adding buyer protection provides an efficiency gain as buyers do not solely rely on the reputation system. In addition, it decreases the markup reputable sellers receive compared to low-reputation sellers. However, it increases the value of purchasing from eBay for buyers, leading to higher prices for all groups of sellers. Furthermore, adding eBay Buyer Protection increases the number and market share of reputable sellers by increasing the cost of dishonest behavior. We develop a model to interpret these results and to get an estimate for change in social welfare: this policy increases the total welfare of buyers and sellers by 12.4% in all transactions and by 19.6% in auctions.

**KEYWORDS** Warranty; Reputation; Adverse Selection; e-Commerce