



Assurance Services as a Substitute for Law in Global Commerce: A Comment

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A phenomenon to be explained

- The explosive growth of “third party assurance organizations.”
- Examples:
 - Canadian Chemical Producers Association: “safe operating principles” for chemical companies.
 - WRAP (Worldwide Responsible Apparel Production): certification that factories are not sweat shops.
 - Equator Principles for Sustainable Development
 - ISO 9000 Standards of Quality Management
 - Social Accountability 8000 (SA 8000) certification program
- What to make of this development?



Blair & Williams' explanation

- These services allow for the organization of business activities and exchange in the absence of the rule of law.
- Key Claim: that in the new Global Economy where legal contracts are often not enforceable and organization of activities within firms is often not possible, third-party, non-governmental inspection and assurance services assume a more prominent role in facilitating exchange.



Preliminary Comment

- Suggestions for further reading:
 - Oliver Williamson, The Economic Institutions of Capitalism (1985), especially Chapter 7 (“Credible Commitments I: Unilateral Applications”) and Chapter 8 (“Credible Commitments II: Bilateral Applications”)
 - Oliver Williamson, The Mechanisms of Governance (1996), especially Chapter 5: “Credible Commitments: Using Hostages to Support Exchange”



My Comment

- Not sure that B & W are using the right framework.
- Not nearly as sanguine as they are about the benefits of the growth of these services.



Right framework?

- An old problem: the challenge of cross border trade, and trade outside the reach of enforceable contracts, goes back hundreds of years.
- Institutions to support exchange: there is a long history of solving the problem of unenforceability in exchange, and a huge variety of solutions.
- A whole literature examining particular arrangements and explaining them on this basis.
- Intuition: Because this is an old problem with old solutions, the explanation for the **emergence** and **explosive growth** of these organizations and standards will NOT be found here.



The classic problem: an example

- Consumer goods case: if the manufacturer cannot credibly signal quality, then consumer will assume low quality and the manufacturer will not receive high price for high quality.
- I.e., exchange (high price for high quality) is frustrated by asymmetric information.
- A variety of standard solutions:
 - Warranties
 - “Assurance Services”



An example of a classic “assurance service”



- Good Housekeeping's Seal of Approval
- This can help solve the problem by allowing manufacturers to credibly signal that they are selling high quality goods.
- Things to note:
 - Good Housekeeping Magazine promises a replacement or refund
 - Only available to advertisers who are accepted
- But does it, in fact, succeed? Do YOU trust it? Does it signal “high quality” or just that a firm advertises in the magazine?
- Before you decide, you'd want to know how often people demand refunds. My guess is almost never which makes me doubt its reliability.



The New Assurance Services

- Example: Nike and sweat shops
- The problem: some consumers find it distasteful that Nike shoes are produced in sweat shops.
- Can't tell by looking at the shoes
- WRAP or SA8000 certifies that Nike's subcontractors don't run sweat shops.



Same problem or different?

- Some similarity:
 - In classic consumer goods context, cannot tell the quality of the good.
 - Here, cannot tell the “social” quality.
- BUT
 - Quality of the stitching or leather goes to the quality of the good.
 - “Social” quality goes to something else: the virtue of the company.
- AND
 - No evidence that inability to judge the virtue of the company leads to a lemon’s problem in GOODS.
 - But could lead to a lemon’s problem in COMPANIES.



The New Assurance Services: a force for good?

- Key discussion in the paper: where is the demand coming from?
- In the first instance, pressure comes from public criticism:
 - Post Bhopal: public outcry about chemical companies → Canadian Chemical Producers Association's "Safe Operating Principles"
 - Public criticism of "sweat shop" conditions
 - → WRAP (Worldwide Responsible Apparel Production): certification that factories are not sweat shops.
 - Social Accountability 8000 (SA 8000) certification program



The Happy Story

- Public demand for virtue leads to the creation of “assurance of virtue” services.
- These services allow virtuous firms to credibly signal virtue.
- Which allows consumers who are willing to pay a high price to a virtuous firm (rather than a low price to a sinful firm) for the same sneakers to do so.



An Alternative (cynical?) View

- “Follow the money”
 - Who profits from these developments?
 - Why do firms give in to the pressure?



A cynical view

- Where does the pressure come from?
- Period 1:
 - Starts with consumer outcry (e.g., against NIKE)
 - but, in the absence of groups that encourage and channel the reaction, consumers tend to lose interest.
- Period 2: firms/groups emerge to take advantage of consumer outrage:
 - Push for the need for standards
 - Write those standards & spread them
 - Push for certification & offer to provide it
- Want to know:
 - Who are these guys?
 - How are they organized?
 - What is their agenda?
 - What do they charge?
 - How much do they make from it?
- A troubling example: Institutional Shareholder Services provides advice on voting to institutional investors, promulgates governance standards, and certifies the governance of companies . . . for which they get paid large sums of money.



A cynical view

- Why do firms respond to the pressure?
- B & W:
 - It helps firms manage their supply chains.
 - It helps firms manage their public relations.
 - They are virtuous and they want the world to know it.
- Some OTHER possibilities (not mutually exclusive)
 - Extortion: May view these demands as extortion, but, so long as the price is not too high, may be willing to pay to avoid bad publicity (see above).
 - Raising Rivals Costs: Some firms may find it easy and cheap to comply and thus have an interest in making compliance mandatory or widespread so as to disadvantage lower cost competitors.
- Interesting discussion in the paper of the Chinese reaction to SA9000: A non-tariff trade barrier.



Why it matters

- Assurance of exchange v. assurance of virtue
- Efficiency Properties:
 - Measures for assurance of exchange are prima facie good.
 - Not as clear that “assurance of virtue” is efficiency enhancing.
- Blair & Williams implicit claim: that the “new assurance services” are both efficient (by facilitating exchange) and virtuous (by making the world a better place).
- An interesting question: under what circumstances will “assurance of virtue” services increase the joint surplus?