Does transparency help or hurt businesses dominated by one-time transactions?

August 5 2024

Credit: RDNE Stock project from Pexels

It's a relevant question for business owners with few repeat customers, such as contract workers or real estate agents: Does being transparent about past business transactions change the odds of making a sale that benefits both buyer and seller?

The answer matters because mutually beneficial sales ensure that these kinds of transactions will continue, keeping the economy strong.

A new study published in the journal *American Economic Review* suggests the answer depends on a variety of factors.

A mutually beneficial sale is defined from two points of view: The seller values the money they receive more than the service they offer, because the price adequately reflects the time and resources needed for that task. Meanwhile, the buyer is satisfied that they received the value they were seeking for the price they paid to acquire it.

This is known by economists as market efficiency—there are no missed opportunities to make a sale from which both the seller and buyer would benefit.

Research from economists at SMU and the University of Miami demonstrates that being transparent about a high volume of past transactions improves market efficiency when a seller has the potential to earn high profits due to the high number of buyers competing to obtain their services. Examples include companies that provide specialized services, like lawyers, accountants or skilled technicians.

Buyers with no previous experience with a seller can observe how frequently the seller has conducted similar transactions and "indirectly infer some of the hidden information about a seller's quality or the value the seller can create," explained study co-author Santanu Roy, University Distinguished Professor of Economics at SMU.

But the situation flips when the market power shifts—when there are more sellers than buyers, Roy and his fellow researcher Ayça Kaya, an associate professor of economics at the University of Miami, determined. "It's actually much worse when buyers observe previously sold quantities," Roy said.

The reason? In these markets, sellers are more likely to heavily discount their services to get new buyers.

Roy said these and other study findings give useful guidance on regulation and design of markets where business owners can't count on repeat customers.

"Should we encourage maintaining reliable records of individual market transactions and making some of this information publicly available to new market participants in the future? The paper provides a nuanced answer to this, one that depends on market competition and fundamentals," Roy said. "Ignoring these factors can make matters much worse."

To analyze whether such businesses benefited from transparency with their past sales, economists Kaya and Roy used what's known as a dynamic game theoretic model with incomplete information.

These models allow economists to factor in multiple parties, when one's outcome may depend on the actions of others. Essentially, they created an artificial world through complex mathematical equations that was simpler than the real world, yet allowed them to make some insights into what would happen in real-life.

"We assumed that the seller encountered a new cohort of buyers every period and we then compared the outcome of a transparent market (new buyers could access reliable records of the frequency or volume of past trading by this seller) with that of an opaque market (buyers had no information about past trading)," Roy said.

Two main things were looked at: how much competition a seller might face and whether buyers were optimistic or pessimistic about the quality of what was being sold.

In this study, the researchers only looked at sellers making the number of past transactions available to buyers, not how much they charged for items, Roy noted.

More information: Ayça Kaya et al, Repeated Trading: Transparency and Market Structure, *American Economic Review* (2024). DOI: 10.1257/aer.20230114

Provided by Southern Methodist University