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Used Vehicles, Lemons Markets, and Used Car Rules: Some Empirical Evidence

ABSTRACT. The purpose of the note is to highlight what the body of economic literature has to say about the subject of lemons markets in general, and used car markets in particular. This literature makes it easier to understand why the FTC might have deleted the known defects provision from its Used Car Rule.

It is shown that the economic literature is divided on whether a lemons market actually exists in used vehicles. The authors' own research is supportive of the hypothesis that the Wisconsin statutes, with its "known defects provision," has been ineffectual in that the mix of used vehicles transacting there is of not significantly better quality than the mix in neighboring states without such legislation.

In a recent article in this Journal, Nicks (1987) methodically recounts the history of the FTC's Used Car Rule (Rule) and critiques the FTC decision to delete the "known defects provision" from the Rule. He examines five major themes, which he argues were used by the FTC Chairman and his staff, to buttress the decision. However comprehensive his discussion, Nicks limited his research to the law literature. In recent years, a sizable body of economic literature has developed on the subject of lemons markets in general, and used car markets in particular; see Akerlof (1970), Bond (1984), Metzger (1983), Pratt and Hoffer (1984, 1985, 1986a, b). Some of this literature (Pratt & Hoffer, 1985, 1986a, b) analyzes consumer experiences in Wisconsin where, as Nicks discusses at length, a used vehicle inspection and disclosure rule has been in effect since 1972. It is the purpose of this note to briefly highlight this literature. With this literature as background, one can better place in perspective why the FTC might have deleted the known defects provision from its Rule.

WHY LEMONS MARKETS EXIST

Few topics have become so engrained in modern folklore than consumers' collective experiences with "bad" used cars — the proverbial lemon. Over time, no single issue has captured the attention

of consumer groups more than how to protect consumers from purchasing a lemon. As Nicks notes, the FTC wrestled with this issue for over a decade before promulgating the present Rule.

The crux of the lemons problem is buyer-seller information asymmetry. A person selling any used product has much more information about its use and the expected probability of future repairs than does a prospective buyer. As Akerlof (1970) has shown, there can be the evolution of both market and non-market responses to the lemons problem. In either case, there is the attempt to provide additional information on product quality.

In the used vehicle market, a number of market and nonmarket responses have evolved. Since the 1940's, each domestic manufacturer has attempted to associate the quality of the better used cars sold by its dealers with that of new cars. For example, once a used vehicle meets certain quality standards, a Chevrolet dealer designates the vehicle as an "OK" used car. Ford and AMC dealers identify their better quality used vehicles as "A-1" and "Select," respectively. More recent market responses have included emphasizing dealer guarantees and offering extended warranties on better quality used vehicles, with the latter underwritten by independent insurers or the manufacturer.

The nonmarket responses to quality uncertainty have evolved through state codes. Each state has adopted some version of the Uniform Commercial Code to define the legal provision of both expressed and implied warranties. Many states have specific statutes that apply only to used vehicles. Some states require that a vehicle undergo a safety inspection prior to original sale and/or resale. Other states have adopted some form of used vehicle disclosure laws. These laws vary from only requiring disclosure of previous police or taxi use (California) to an extensive vehicle condition checklist (Wisconsin).

THE RECENT ECONOMIC LITERATURE

In the economics literature, there is some question as to whether or not the used vehicle market can in fact be classified as a lemons market. Bond (1982) first raised the issue of whether the used vehicle market was a lemons market, and consequently, whether any nonmarket response was appropriate. Because of the lack of neces-