Flat Rate Pricing and Inefficiency Mitigation in Credence Goods Markets: Evidence from the Taxi Industry

By WEI MIAO AND JUNHONG CHU*

Few proposed remedies on seller inefficiencies in credence goods markets have been tested with observational data. We take advantage of an exogenous policy change that a taxi company in Singapore added an origin-destination-based flat fare option to its existing metered fare option to examine the effect of flat rate. We find that flat rate significantly reduces driving distance and trip duration. The effect differs by the driver’s degree of honesty, driving arrangements, and experience. The efficiency gain predominantly arises from an honesty-inducing effect with no learning present. We also find positive spillover effects from flat fare trips to subsequent trips. (JEL D82, J22, R41)

I. Introduction

Taxi service is classified in the economics literature as credence goods, which are those goods and services characterized by pronounced information asymmetry between sellers and buyers: Sellers typically have information superior to that of buyers regarding the true quality of the products and services provided. The term, which was coined by Darby and Karni (1973), signifies the importance of the seller’s honesty in such markets, as buyers are incapable of identifying the quality by themselves and must heavily rely on the judgment of ostensible experts—who, at the same time, are the sellers.

Credence goods markets are inevitably plagued by sellers’ fraud-induced inefficiencies. Three types of inefficiencies have been discussed in the literature: (1) overtreatment, which refers to that sellers, in order to earn more, provide a service of longer duration or

* Miao: NUS Business School, National University of Singapore, 15 Kent Ridge Drive, Singapore 119245, Singapore (email: miao.wei@u.nus.edu); Chu: NUS Business School, National University of Singapore, 15 Kent Ridge Drive, Singapore 119245, Singapore (bizcj@nus.edu.sg). We gratefully acknowledge funding from Singapore Ministry of Education Social Science Research Thematic Grant, MOE2016SSRTG-059, SPIRE. We are very grateful to a major taxi company in Singapore for providing us with the data for this research, and deeply indebted to its management team for sharing with us their insights on the taxi industry.