Reputation for Quality
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ABSTRACT

We propose a new model of firm reputation where product quality is persistent and determined by the firm's past investments. Reputation is then modeled directly as the market belief about quality. We analyze how investment incentives depend on the firm's reputation and derive implications for reputational dynamics. Reputational incentives depend on the specification of market learning. When consumers learn about quality through good news events, incentives decrease in reputation and there is a unique work-shirk equilibrium with convergent dynamics. When learning is through bad news events, incentives increase in reputation and there is a continuum of shirk-work equilibria with divergent dynamics. Across all imperfect learning processes with Brownian and Poisson signals, we show that when costs are low there exists a work-shirk equilibrium with convergent dynamics. This equilibrium is essentially unique if market learning contains a good news or Brownian component.

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