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If Life Gives You Lemons …

Why you can never buy a decent used car.

By Tim Harford

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I recently did something that is, in theory, most unwise: I bought a secondhand car. Since economists hate to compromise between safety and style, it was a Volvo. You'd think I would know better. The American subtitle of my book is, "Why you can never buy a decent used car."

In 1966 an assistant economics professor, George Akerlof, tried to explain why this is so in a working paper called "The Market for 'Lemons.' " His basic insight was simple: If somebody who has plenty of experience driving a particular car is keen to sell it to you, why should you be so keen to buy it?

Akerlof showed that insight could have dramatic consequences. Buyers' perfectly sensible fears of being ripped off could, in principle, wipe out the entire used-car market: There would be no price that a rational seller would offer that was low enough to make the sale. The deeper the discount, the more the buyer would be sure that the car was a terrible lemon.

More plausibly, only the market for cheap, shoddy used cars would survive. A person with a good car would hold onto it because he couldn't prove it was good and so wouldn't expect an attractive offer for it. And if the good cars aren't put up for sale, the lemons will be what is left. This is a problem not just for buyers, but for sellers, too, who wish they could be trusted.

Many people recognize that they are reluctant to sell their own car if it's running well. That is informal evidence for Akerlof's thesis, since if buyers were able to appreciate the qualities of each car, good cars would fetch more money and it should be no more attractive to sell a cheap lemon than an expensive peach.

But the used-car market hasn't disappeared, and so economists have debated how much Akerlof's model really explains the market. For instance, there's been a lively controversy as to whether pickup trucks that are sold secondhand have higher maintenance bills than pickup trucks of the same age that are not sold. (If they do, that's evidence in favor of Akerlof's "lemons" model.)

But that is not really the point, because used cars were just the beginning for Akerlof. His neat little paper was turned down by two top journals because they couldn't see past the trivia of his example. He recalls that a third, the *Journal of Political Economy*, had a better reason for rejecting him: The paper couldn't be true, because if it were true then economics would be turned on its head.

The *Journal of Political Economy* was half right. Akerlof did turn economics on its head—and eventually received the Nobel Prize for doing so—not by documenting the travails of used-car buyers and sellers, but by showing how corrosive a little bit of inside information can be to all sorts of markets. Insurance, including health insurance, is one possible casualty. If you eat well, exercise, and have parents who lived to 100, you might expect a big discount from your health insurer. If you do not get the discount, you may decide to take your chances without health insurance, especially if you are not getting a subsidy from an employer. And if, as a good health risk, you decide not to insure yourself, the average cost of premiums will have to rise. Other people may decide to join you. The same goes for loans and mortgages, too: Some people simply cannot get a loan, no matter how much interest they offer to pay. Progressively higher interest rates scare off increasing numbers of creditworthy borrowers, leaving only the bad risks.

Then there's the market for jobs. How many of your colleagues are lemons? If you're competent but can't prove it to your boss, you may prefer to be a freelancer. If other competent workers think that way, it may explain why you think your colleagues are idiots and they think the same about you.

These problems can be solved, but at a cost. Mortgage companies can cut out high-risk borrowers, but at the cost of refusing credit to whole neighborhoods. Employees spend years acquiring qualifications with little value other than proving that they're smart and work hard. And used-car buyers will look for trusted sellers, even if that raises the cost of doing business. I bought my Volvo from my brother-in-law because I thought that would lower the risk of being sold a lemon.

Not only are the solutions costly, they don't always work. My Volvo lasted less than a fortnight before the clutch burned out: a bitter little lemon after all.

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