Third-Party Services for Voluntary Labeling

Third-party services could change the private, voluntary labeling decision of firms by either reducing the costs or increasing the benefits of labeling. These services bolster the credibility of voluntary labeling, thereby facilitating market transactions and increasing market efficiency. These services could prove valuable in both domestic and international markets. The primary services that third-party entities offer to help strengthen labeling claims are standard setting, testing, certification, and enforcement.

Standards. Standards establish the level of quality that a good must possess. Standards set by third-party entities facilitate market transactions to the extent that the standards are recognized by numerous producers and consumers. Successful third-party standards establish a common terminology for goods possessing the same quality characteristics. Without standards, many market transactions would require lengthy negotiation about the quality characteristics of a product. Standards could also establish the way that labeled information is presented, ensuring that information is provided in a uniform manner, allowing consumers to compare products more easily.

Testing services. Third-party testing services help producers strengthen their claims of product quality by providing a more objective measure of product attributes. Particularly for credence attributes, testing services increase the value of the information provided by the label. In addition, third-party testing services could reduce the costs of verifying that standards have been met. If the average cost of testing declines with the volume of tests run, it may be less expensive for one party to provide testing for many firms rather than for each firm to test or for each consumer to try to test the veracity of product claims. In some cases, testing is not possible and identity-preservation systems, in which product quality is assured by strict segregation and tracking systems, may emerge.

Certification. Third-party certification provides assurances to consumers that the information supplied by firms is correct. Consumers may question the validity of the information provided by firms, particularly for credence goods. Third-party certification provides consumers with an objective evaluation of the product's quality attributes and helps firms establish credible market claims. Third-party certification could also be used to establish the credentials of other third-party services, including other third-party certifiers. Accreditation is a process for certifying certifiers (Toth, 2000, discusses this point).

Enforcement. Third-party enforcement of quality standards provides further assurances that quality claims are valid. If firms making fraudulent claims are penalized, incentives to make truthful claims are strengthened. The more onerous the penalty for fraud and the higher the probability of being caught, the more reliable quality claims are likely to be. Third-party enforcement services include watchdog services, de-certification, and legal requisites. Watchdog-type enforcement services rely on negative publicity to discourage fraud. Firms with valuable reputations will be most susceptible to this type of enforcement. De-certification provides a clear indication that a product has failed to comply with quality standards and represents the most powerful enforcement tool available to most private third-party certifiers. De-certification by government entities could carry the added penalty of prohibiting marketing of the product. Legal requisites concerning advertising provide the ultimate enforcement against fraudulent quality claims, even for voluntary claims.

Third-party services can be provided by a wide variety of entities, including consumer groups, producer associations, private third-party entities, national governments, and international organizations. For example, the Good Housekeeping Institute, founded for the purpose of consumer education and product evaluation, sets product standards and provides consumer guarantees for a wide range of goods including foods; the American National Standards Institute (ANSI), a nonprofit membership organization, facilitates development of voluntary private-sector standards for a wide range of products; Underwriters Laboratories (UL), a private nonprofit entity, provides standards and certification, primarily for electrical appliances; the Council of Better Business Bureaus works with the National Advertising Review Board to investigate questions of truth and accuracy in national commercial advertising; the USDA's Agricultural Marketing Service (AMS) has established standards for 233 agricultural commodities; and ISO, a worldwide federation of national standards

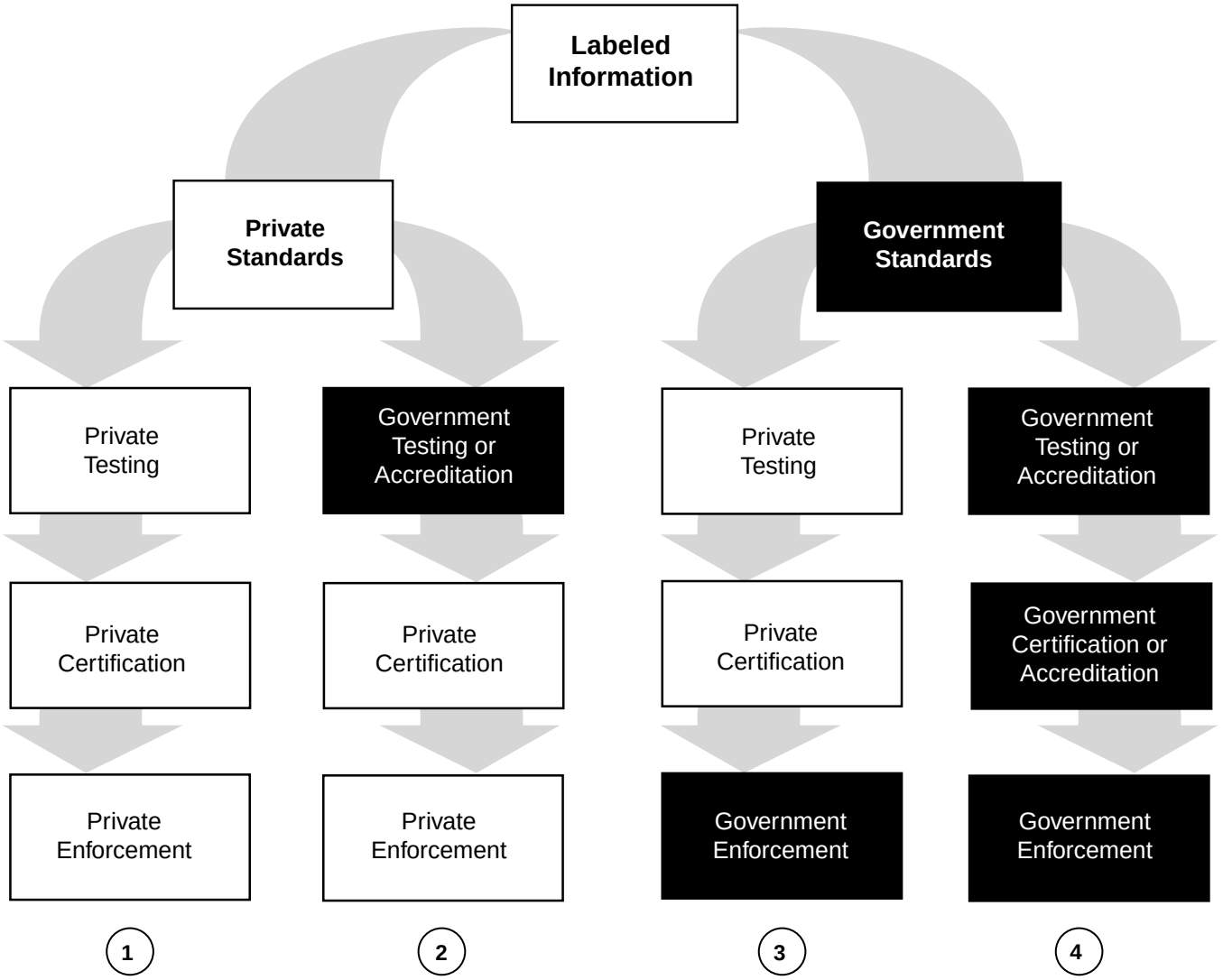
bodies, promotes the development of standardization and international standards for a wide range of products.

Figure 1 illustrates the mix of service providers available to producers to bolster the credibility of voluntary labeling claims. Producers could employ just one or two labeling services, or they could employ a combination of the four. For any branch along the labeling services tree, the government provides an ultimate enforcement: fraud is always subject to legal sanctions. Even with private standards and private testing and certification, the government, through laws prohibiting fraudulent and deceptive advertising, plays a role in enforcing the truthfulness of product claims.

The first branch of the labeling tree shows the case where a private third-party entity sets standards, provides testing and certification, and enforces truthful compliance with standards. There are many examples of this case, including most kosher labeling and private organic standards (such as those set and administered by Oregon Tilth).

The second branch of the tree illustrates the case where private entities set standards, and provide certification and enforcement, but the government assists in the process by providing testing services or accreditation of testing services. Such a situation could emerge when standards are technically difficult to test for and gov-

Figure 1. Labeling tree



ernment services help establish testing norms. For example, USDA's Grain Inspection, Packers and Stockyards Administration (GIPSA) has established a reference laboratory to evaluate and verify the validity of analytical techniques applied to the detection of genetically enhanced traits in grains and grain products.

The third branch of the tree illustrates the case where the government sets voluntary quality standards and provides for protection against fraud, but relies on private testers and certifiers to guarantee that standards have been met. In some cases, the voluntary standards set by AMS are certified and enforced by private entities.

The fourth branch of the labeling tree shows the case where the government is responsible for providing or accrediting providers of all four services. For example, many States set standards for organic foods and provide certification and enforcement services. This branch of the labeling services tree also depicts the case where the government requires labeling, as will be discussed in the next section of the report.

In general, the value of the labeling service depends on the credibility and reputation of the entity providing the service. Services provided by entities that are trusted and well known by a large number of consumers will be most successful in reducing search and information costs, facilitating market transactions, and increasing market efficiency. In many cases, national governments or associations of national governments may be the most widely recognized and reputable third-party providers of labeling services. However, this is not always the case. For example, although U.S. consumers tend to have confidence in USDA and FDA to regulate food safety, Europeans rank national bodies and industry far below international, environmental, and consumer and farm organizations in terms of trustworthiness (Gaskell et al., 1999).

The value of third-party labeling services also depends on the extent to which they are responsive to consumer preferences and technological capabilities. This is particularly true for standards. If standards are more lenient or strict than consumer preferences, consumers will search out goods with quality standards that match their preferences more closely. For example, if standards are so strict that production costs rise beyond consumers' willingness to pay, consumers will seek products with lower standards (which may be difficult, if not impossible, to find if standards are legally mandated). If standards surpass the technological ability of producers to meet or of consumers to verify, they will eventually lose their value. For example, a standard that sets a zero tolerance level for biotech ingredients in non-biotech oils would be virtually impossible to verify given the current state of biotech testing. Neither consumers nor producers would be able to test compliance, and the standard would become meaningless.

The most flexible standards with respect to changes in consumer preferences or technology may actually be those set without third-party participation. In the absence of third-party standards, producers and consumers must establish standards and quality requirements through contractual agreements—most of which are updated periodically to reflect changes in consumer preferences and technologies. Standards set by government or international organizations may often be the least flexible and most difficult to modify in response to changes in preferences and technologies. For example, the Delaney Clause (Federal Food, Drug, and Cosmetic Act) prohibits the use of any food additive found to induce cancer in humans or animals, no matter how small the risk. This prohibition was not considered overly restrictive when it was written into law in the 1950's. However, since then, chemical detection sensitivity has increased by several orders of magnitude, and carcinogens have been detected in foods once considered hazard free. For pesticides, the Environmental Protection Agency tried to substitute a negligible risk standard, but litigation in the 1990s required the agency to comply with a strict interpretation of the Delaney Clause. A major change in pesticide legislation (Food Quality Protection Act, 1996) was required to mitigate the problems the Delaney Clause raised for regulators, consumers, and the agricultural sector.

Standards can also be misused, as when they are used to establish barriers to entry benefiting a particular, usually well-established group of producers. Such standards not only suppress fair competition, they hinder innovation and technological change. These standards are costly to consumers and to market development.

If properly designed and implemented, third-party standard setting, testing, certification, and enforcement all increase the value of a label by increasing the reliability and credibility of the labeling claim. These services reduce uncertainty for producers, reduce search and information costs for consumers, and increase the likelihood that consumers will purchase those goods and services that best match their preferences. Because they increase the value of information, these third-party services can increase the amount of information that

producers choose to provide to consumers through product labels. These services can enhance the efficiency of domestic and international markets.

Though potentially very valuable, third-party services can work only with producer incentives. These services cannot change producers' fundamental reluctance to disclose information about undesirable product characteristics. Other mechanisms must be employed to encourage disclosure of important negative product attributes. In the next section we examine the role of government in mandating labeling.