Chapter 7
Fairness
Ethics
Trust
Altruism

How do perceptions of fairness and ethics cause decisions to deviate from rational behavior?

How do trust and altruism influence our decisions?

Accepting a Job Offer

You are graduating from a good MBA program. Subsequent to your discussions with a number of firms, one of your preferred companies makes you an offer of $110,000 a year, stressing that the amount is not negotiable. You like the people. You like the job. You like the location. However, you find out that the same company is offering $120,000 to some graduating MBAs from similar-quality schools.

Will you accept the offer?

Are you bothered by the fact that they receive less than others even though they may be happy with the job offer without knowing about the salaries of others.

Price Increases: Fair or Unfair?

1. Pizza place raises price from $10 to $15 because their rent went up.
2. Ski resorts charge higher prices at Christmas.
3. In recession, your employer changes your job description and you get a 10% wage cut.
4. In the aftermath of a hurricane, a small building-supply company more than doubles its prices on many items that are in high demand, such as lumber.
5. A hardware store has been selling snow shovels for $15. The morning after a large snowstorm, the store raises the price to $20.

Rational from economics point of view?

Framing and Fairness: Fair or Unfair?

A company is making a small profit. It is located in a community experiencing a recession with substantial unemployment. Many workers are anxious to work at the company.

a. There is no inflation. The company decides to decrease wages and salaries 7% this year.
b. Inflation is 12%. The company decides to increase wages and salaries 5% this year.

Perceptions of fairness are sensitive to framing. Real wages decreased 7% in both cases, yet most people perceive (a) as unfair, (b) as fair.

Framing and Fairness : Fair or Unfair?

A shortage has developed for a popular model of automobile, and customers must now wait two months for delivery.

a. A dealer has been selling these cars at list price. Now the dealer prices this model at $200 above list price.
b. A dealer has been selling these cars at a discount of $200 below list price. Now the dealer prices this model at list price.

Perceptions of fairness are sensitive to framing.

The Ultimatum Game

1. The proposer decides how to divide the money (say $10)
2. The responder can choose to accept the division, or to veto the division
3. If accepted, both receive the division, if rejected, both receive zero

• What behavior do you expect and why?
• Theory says the proposer will offer a tiny fraction of the prize; the recipient will accept
  • Any amount is better than nothing.
  • The proposer should propose that he will keep all of the money, bar some minimal amount, because the receiver will accept any offer.
Fairness and social norms

**Fairness** is willingness to sacrifice to reward intentions of kindness and to punish intentions of unkindness of others.

The social norm of “fair” being about 50-50 results in a desire by the other to punish you if you are “unfair.”

- **Generosity** is willingness to share at own expense
- **Revenge** is willingness to harm others at own expense.
  - Many subjects reject offers < 20% of total.
  - We derive more utility from punishing unfair act than from small share of the pie.
  - The threat of rejection produces larger offers.
  - People care about outcomes, relative to others: “Why should I get less than him”, “Why should I get more than him?”
  - People desire **reciprocity**: If someone does good (or bad) to me then I want to do good (or bad) to them.
  - **Reciprocity** rewards actions that are kind and punishes actions that are cruel.
  - Emotions (anger, indignation) influence economic decisions
    - We are offended by low offer

Real life example of ultimatum game

- American Airline flight attendants had a long salary dispute. Finally as AA was going bankrupt, they accepted billions of dollars in lower pay.
- 2 days later, the executives received millions of dollars in pay bonuses for settling.
- The flight attendants called the deal off, even though the millions of dollars were insignificant compared to the deal they accepted.

A neuroscience perspective

- We tend to activate parts of the brain associated with negative emotion when considering unfair offers.
- Punishment of cheaters involves activity in a region of the brain associated with satisfaction
  - people derive utility from punishing unfair behaviors, even at expense
- Monkeys tend to respond to unfairness by refusing to work for rewards.

A simple ultimatum game

**Experiment** (Falk, Fehr, Fischbacher)

- **Design**: In game 1, proposer could either offer 5/5 or 8/2. In game 2, proposer could offer either 8/2 or 2/8
- **Results**: In game 1, 44% reject an 8/2 split In game 2, 27% reject an 8/2 split

- How can this be explained?

Fairness in teams

Team effort suffers from the free rider problem.
Why should I work harder than others?

Questions

- How would fairness preferences affect team performance for good? for bad?
- How should managers respond to teams with fairness preferences?

Different cultures

- People all over the world played the ultimatum game.
- Fairness is an important consideration in every society that has been tested, though its strength may vary across cultures.
- Cultural differences are significant and range from competitive
Evidence of Altruism: The dictator game

1. “Dictator” is given $10. He can offer any share or none to the other player.
2. The other player must accept, regardless how small.

- Do Dictators keep all money for themselves?
  - No.
- A real-world analogue to a dictator game is pay-what-you-want pricing. The concept behind pay-what-you-want pricing is that consumers can purchase a product for any product that they like, including $0.
  - Though people pay less for products under a pay-what-you-want format than under a more traditional format, many more people purchase products and in some cases, profits can be higher under a pay-what-you-want scheme than under a more traditional scheme.
  - People rarely pay nothing for products even though they have the opportunity, which suggests that fairness is an important consideration to them.

Example: Dictator game with children

Experiment (Harbaugh, Krause, Liday)

- Design: Had 310 2nd, 4th, 5th, 9th, 12th graders play the dictator game with 10 tokens worth $0.25 each. Adults give on average $2.
- Results: 12th grades behave like adults giving 2.1 on average. The youngest gave 0.35. Those in the middle gave 1.5.

Dictator game with pictures

Experiment (Burnham)

- Design: Played the $10 dictator game with pictures
- Result:
  - When the receiver received a picture, 25% gave $5 (compared to 3.8% in the case without the picture)
  - When the sender received a picture, 25% gave $5

Questions
- Why?
- Implications for Save the Children?

Does Altruism exist?

- Economists assume people are selfish.
- Altruism is helping others for no apparent practical gain.
  - US parents devote $227,000 on average to raise a child.

- Is caring for others rational?
- Is altruistic behavior in exchange for some future reward (the Christian notion of heaven) still altruism?
- Is being altruistic for the warm glow feeling you get still altruism?

Is altruism good?

Spoiling a child

- A parent who is too altruistic may spoil the child.

Family firms

- Family firms have a poor success rate across generations.
  - Only 1/3 make it to 2nd generation. Only 1/6 make it to 3rd.
- Altruistic incentives may lead to inefficient family owned firms.

The deadweight loss of Christmas

- Altruism can be inefficient.
  - Parents buying gifts for their children on Christmas creates deadweight loss because they may not know the preferences of their children.
  - CD with Xmas songs: parent paid $14, child values at $1
  - Gifts are expensive signals of respect / love
  - Economists’ suggestion: give cash instead

Evolutionary biology perspective on altruism

- Altruism can be explained by:
  1. kin selection
    - what’s good for my family is good for me.
  2. signaling mechanism
    - like a peacock’s tail feathers.
  3. avoidance of punishment
    - As in the ultimatum game, we don’t want to be rejected.
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Trust

- **Trust**: firm belief in the reliability, truth, ability, or strength of someone or something.
- Imagine hiring a teenager to paint your house.
  - If you trusted them, you can let them paint on their own.
  - If you didn’t you would have to monitor, increasing transaction costs.
- Handshakes and verbal agreements work in business.
- Trust is why brand names matter.
- In everyday economic interactions, we trust:
  - doctors to provide good care
  - mechanic to fix our car
  - used car salesman to not offer a lemon
  - waiters to use clean plates.

Subtle things create trust
- A waitress who smiles gets more tips
- A supermarket that gives free samples gets more business
- Trust is why brand names matter.
- In everyday economic interactions, we trust:
  - doctors to provide good care
  - mechanic to fix our car
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Trust Game

**Experiment** (Berg Dickhaut McCabe)

**Design**: Two players, a sender and receiver each received $10.
- Sender could send up to $10 to Receiver
- Any amount sent is tripled
- Receiver could keep or send any amount back

**Results**:
- Senders send $5.16 on average.
- Receivers return $4.66.
**Question**: What would selfish actors do?

- Repeating the experiment with new subjects, but showing them the results of the first experiment, senders gave slightly more on average $5.36
- 3 of 28 did send 0 but 7 of 28 sent the full $10
- Possibly the previous information conveyed a social norm

Social Capital and Trust

**Experiment** (Glaeser et al)

**Design**: Measured social connections of subjects. Then had them play a trust game where the receiver was allowed to make a *cheap talk* promise to return at least as much.

**Results**: Those who made the promise were more likely (68% versus 48%) to return at least as much as what was sent. Each month of knowing each other increased amount sent by $0.10. Receivers sent back 0.6% more for each month.

Possessing social capital seemed to increase trust and perhaps trustworthiness

**Finding** (Knack and Keefer)

- In a survey of 21 countries, measures of trust and social capital are associated with faster GDP growth.

Public goods: free rider problem

- A town wants to build a new bridge, costs $1,000,000
- The bridge will attract new business, total benefit to be $4,000,000
- There are 1,000 residents
- If each contributes voluntarily $1,000 the bridge will be built

**How much will you contribute?**
**How can we make people contribute?**
**Is trust an important factor?**

Example Who do we trust?

**Experiment** (Stanley Sokol-Hessner Banaji Phelps)

**Design**: Played the trust game with various pictures, varying the race.

**Results**: Both white and black senders sent exactly the same amount regardless of race.

Survey measures of trustworthiness did not vary by race either.

**Experiment** (Glaeser et al.)

- Found gender had little effect.
- Also found little effect of race on trust.
- Women are generally more reciprocal than men, while men are more trusting.
- But they did find that in white-white sender receiver pairs, reciprocity was 10% higher than un-matched pairs.
Experiment (Carter and Castillo)

• Design: Ran a trust game in 14 communities in South Africa using two days wages.
• Results: Found that high levels was associated with higher reciprocity.
• More trust was associated with higher expenditures (well being)
• Reciprocity was associated with higher expenditures as well but only in urban settings.

Example Economic Consequences of Trust

More on race and gender

Experiment (Debruine)

• People are more trusting toward pictures of people computer morphed to look like them.
Question: Implications for advertising?

Thought Questions

1. Why must trust and reciprocity co-exist? Why does that make the measurement of trust difficult?
2. Describe an example of how trust reduces transaction costs. What institutions facilitate trust?
3. How might a bank manager facilitate trust?
4. How do the findings here apply to job interviews?

Organizations

• When a group of individuals play the role of proposer and responder in ultimatum and dictator game they typically offer less, and reject less.
• Interacting in a team lowers individual offers
• Implications for unions-management negotiations?
• Decision-makers should consider the perceptions of others before making decisions involving fairness considerations.
• Even though fair allocations to others may not be in an individual’s best short-term financial interest, long-term interests may be best served by making decisions that will be perceived favorably by others.

Fairness and Equity Pay differentials

• Pay differentials
  - Companies with more pay equity tend to produce better products than ones with pay inequity.
  - Major league baseball teams with more pay equity tend to perform better than those with pay inequity.
  - The gap between CEO pay and the pay of the average executive is negatively correlated with performance.
• We use others’ outcomes as reference points to help us determine the acceptability of our own outcomes
  - Though we tend to consider pay inequity to be unacceptable even when it means we would accept a lower salary that puts us on par with the salary of others
  - Our perceptions of fairness are also dictated by whether we evaluate options jointly or separately.
    - When evaluating outcomes separately, we often rely on others’ outcomes as a reference point for what we should consider to be a fair outcome for ourselves.
    - When evaluating outcomes jointly, we often adopt a more rational mindset and favor the most favorable outcomes while ignoring the outcomes of others.

Perverse Consequences of Equality Norms

Watch out: Fairness can be an arbitrary artifact of the situational framing and prior offers.

You visit a car dealer and go on a test drive. You return to the salesperson’s cubicle in the showroom, ready to do a deal. The car has a list price of $18,000. After a short discussion, you offer $15,500. The salesperson counters with $17,600, you counter with $16,000, he counters with $17,200, you counter with $16,400, and he reduces his price to $16,800. You act as if you will not make another move and threaten to visit another dealership. The salesperson then says earnestly, “You look like a nice person, and I can see that you really like the car. My main concern is that you get the car that you want. I assume that you are a reasonable person, and I want to be reasonable. How about if we split the difference—$16,600?”
Bounded Ethicality

Bounded ethicality is unethical behavior that occurs outside of our conscious awareness.

1. Overclaiming credit
   - Partners overestimate % of household chores they do vs. our contribution to joint ventures
   - Each party often feels justified in reducing its contribution to chores vs. joint venture

2. In-group favoritism (favor in-group over out-group members)
   - People are less likely to associate positive characteristics with out-group members than with in-group members.
   - People are less likely to punish unfair behavior of demographically similar others

3. Implicit attitudes
   • Over-reliance on unconscious attitudes & stereotypes about others
   • We require conscious effort that is cognitively taxing in order to suppress our negative stereotypes

4. Indirectly unethical behavior
   - behavior that harms others indirectly
   Prescription Drug Prices example
   A major pharmaceutical company is the sole marketer of a particular drug. The drug is not profitable, due to high fixed costs and a small market size, yet the patients who do buy the drug depend on it for their survival. The company currently produces the drug at a total cost of $5/pill and only sells it for $3/pill. Which option is more ethical?
   A. The company raises price from $3/pill to $9/pill?
   B. The company sells the rights to produce the drug to a lesser-known pharmaceutical company. The new company raises price to $15/pill.
   • Due to the indirect nature of the price increase, outcome (B) is seen as more fair.
   • When people evaluate both scenarios jointly, they are more rational
   - People protect their perception of themselves as ethical individuals.
   - People will keep themselves ignorant about the economic outcomes of others when they have the opportunity to select an option that is in their economic best interest.
   This probably allowed participants to feel that any potential harm to others was indirectly caused by them since they did not have a conscious awareness of others' payoffs.

5. Pseudo-sacred values
   • Acceptable trade or not?
     • Paying for sex
     • Paying for organs
     • Paying for babies
     • Illegal immigration
   - Our need to uphold moral values may be unconscious and irrational.
   - A study asked people to sign an explicitly meaningless paper asking them to sell their soul in exchange for $2, they rarely did so. When asked to rationalize their decisions, people had difficulty articulating why they did not sign the paper.

6. Conflicts of interest
   Conflict between our self-interest and the interest of others leads to biased decision-making despite our best intentions not to be biased by self-interest.
   • Disclosure does not decrease, may increase this bias
   • Motivated blindness (failure to notice information that challenges our self-interest)
     • Financial analyst providing ‘buy’ recommendations, may not recommend to sell their client’s stock
     • Major League Baseball officials too preoccupied with profit to notice steroids use
     • Catholic Church high officials did not react to child abuse signs for fear of tarnish reputation of church
     • Credit-rating agencies are paid by clients to rate their assets
   • Addressing conflicts of interest
     • Eliminate them
     • Disclosure to others (may not work)
     • Recognize your own susceptibility to bias, watch for it

Cheating

• See course web site for evidence