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Keeping your gains close but your money closer: The prepayment effect in riskless choices

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ABSTRACT

Although research on loss aversion now spans more than three decades, researchers are still debating whether (or in which cases) the finding holds true for money. We contribute to this debate by exploring how prepayment affects financial decisions. In one set of experiments, we show that when faced with a tradeoff between post- and prepayment, participants overvalue prepaid money, and sometimes even prefer it over objectively higher gains. Importantly, this effect was more pronounced when prepayment was more distant from its pure representation in dollars and cents (Experiment 1A), as well as when potential losses were directly linked to specific options (Experiment 1B). As far as the processes involved, our results suggest that prepayment leads to increased personal commitment to prepaid options (Experiment 1C). In a second set of experiments, we show that even when the tradeoff element is eliminated, participants are more motivated and engaged in a task that is prepaid rather than post-paid (Experiments 2A and 2B). Based on our findings, we discuss how firms can use prepayment mechanisms to get more out of their agents, and how individuals can be motivated to better utilize their money.

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1. Introduction

Imagine you are the CEO of a company that sells financial services (e.g., insurance). Intermediaries sell your products alongside those of competing companies, and you want your products to be promoted above others. To beat the competition, you could pay intermediaries a higher commission for selling your products – but this could get pricey. Alternatively, imagine that you paid the standard commission for your products but you did so in advance – the same amount of money, only paid up front rather than after the sale. Under this *prepayment* approach, intermediaries are required to pay you back the prepaid commission for any of your products that they fail to sell. With this type of tradeoff scenario, in which they must choose between your prepaid products and other (post-paid) products, would they promote your products over others? Would they do so even if time discounting would play no role and if they would clearly earn less overall? Or when faced with both yours and the competitors' products, would they invest more time and effort in selling your products to try and avoid losing the prepaid commission? Of course, if the intermediaries adhere to the principle that “money is money,” or “all dollars are born equal,” they should treat prepaid money in exactly the same way as their standard post-paid commission and promote the products that maximize their payoffs. However, if the intermediaries violate the principle of fungibility, they might be reluctant to give up the prepayment – even when it would be economically inefficient.

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Although the timing of the payment should, in principle, have no effect on how it is valued, decision making literature suggests that the question of whether prepayment will have an effect on individuals' choices and effort depends on whether money (in the form of prepayment or otherwise) is perceived as a loss or as a foregone gain (Novemsky and Kahneman, 2005). According to the theory of loss aversion (Kahneman and Tversky, 1979), individuals are more sensitive to the possibility of a loss than they are to the potential for an equivalent gain. Thus, if prepayment is perceived as a loss, this should lead to the overvaluation of prepaid money and an over-eagerness to sell prepaid contracts in order to avoid the loss of the received payment. In contrast, however, overvaluation of prepaid money would not be expected in cases where this money is not perceived as a loss.

In choices under risk, the accumulated evidence supports the former interpretation. For example, Davis et al. (2010) found that providing a show-up fee for participants at the end of the experiment (post-payment) leads to a house money effect (Thaler and Johnson, 1990) whereby individuals are more risk-seeking because they do not yet consider the money to be theirs. In contrast, when a show-up fee is administered as a prepayment (before the beginning of the experiment), participants are risk-averse because they are more reluctant to lose their "own" money. Rosenboim and Shavit (2012) further supported these findings by showing that when the prepayment is given to participants two weeks before the experiment, the willingness to take risk decreases since the participants are even more strongly tied to the prepaid money. In riskless choices, however, the picture is much more nuanced.

A straightforward reading of reference-dependent preference theory (which models loss aversion in riskless choices; Tversky and Kahneman, 1991) suggests that the act of giving up money (e.g., forfeiting a prepaid commission for a post-paid commission) is construed as a foregone gain rather than a loss (see also Idson et al., 2000; Kahneman and Sugden, 2005; Köszegi and Rabin, 2006). Thus, a riskless choice between payment before or after the delivery of goods or services merely reflects a comparison between the gain of the post-payment and the (foregone) gain of the prepayment. From this perspective, no special effect of prepayment should be expected. In line with this approach, Novemsky and Kahneman (2005) attempted to define clear boundary conditions for loss aversion. One of their conditions suggests that goods providing the same benefits are not perceived as losses, and can thus be exchanged without subjection to loss aversion (e.g., selling an old car to buy a new one). Similarly, a second boundary condition suggests that when goods are intended for exchange from the start, they are not perceived as losses (for related arguments, see Ariely et al., 2005; Kahneman et al., 1990, 1991; Köszegi and Rabin, 2006; Thaler, 1980). Thus, these boundary conditions imply that intermediaries – who expect to be compensated for their services in order to purchase other goods and commodities – would readily forfeit their prepaid commissions in order to obtain similar or higher amounts of money in post-paid commissions.

However, a different outcome is predicted by Bateman et al. (1997) who propose an alternative reference-dependent model. According to Bateman et al., any reduction in the status quo (even in the form of money that is given up in routine transactions) is considered a loss, and thus leads to loss aversion. Accordingly, since individuals should be more sensitive to losses than to equivalent gains, prepayment should be overvalued and personal commitment and engagement to the prepaid option should increase. Recently, an adversarial collaboration has formed in an attempt to reconcile these competing models (Bateman et al., 2005). The authors surmise that loss aversion for money could occur under specific conditions (e.g., in cases where individuals perceive themselves as having no budget reserves), and highlight the need to further examine the moderators of loss perception for money (see also Novemsky and Kahneman, 2005). The aim of the current paper is to contribute to this venture by examining the conditions under which loss aversion for money in riskless choices is stronger or weaker.

Similar to Rosenboim and Shavit (2012), we propose that one central moderator determining when prepaid money is treated as a loss can be derived from the rationale of mental accounting (Thaler, 1980, 1999). Mental accounting suggests that individuals evaluate their assets differently depending on how these assets are mentally labeled, leading to violations of the principle of fungibility (Thaler, 1999). Heath and Soll (1996) extended this theoretical framework to budgeting and consumer behavior (i.e., mental budgeting). Here, we posit that when money is represented in its pure form as cash, the principle of fungibility will *not* be violated, resulting in no effect of prepayment. However, in many real-life situations, money is labeled or framed in a multitude of shapes and flavors (see Levav and McGraw, 2009), many of which distance it from its pure cash representation and instead associate it with more tangible resources. For example, Mazar et al. (2008) used tokens as a substitute for money to examine unethical behavior. Although in this experiment the tokens were exchanged for cash almost immediately, participants cheated to a higher degree when receiving tokens than when they received money. In a similar vein, field research shows that consumers make more purchases when they use credit cards (a more distant representation of money) than when they use cash (Feinberg, 1986; Hirschman, 1979; Prelec and Simester, 2001; Raghurir and Srivastava, 2008; Soman, 2003). These results suggest that distancing money from its pure cash representation affects the way it is perceived and ultimately utilized. Under the same logic, we argue that when money is mentally represented as something more tangible than its dollar amount, it is more likely to be perceived as a loss. Under these conditions, we predict that with such distance, people will exhibit more commitment and engagement in prepaid tasks to avoid losing the prepaid money, even when it is clearly irrational to do so.

To examine these research questions, we conducted two sets of experiments. In the first set (Studies 1A, 1B, and 1C) we focus on settings in which individuals make a tradeoff between selecting a prepaid option and returning the prepaid sum in favor of a postpaid option. In these types of situations, individuals make a direct tradeoff between keeping their prepaid money and losing it in exchange for a different payment. In the second set of experiments, we focused on situations with no tradeoff, in which individuals can work under both types of payments (or just one) at the same time, and thus do not need to

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