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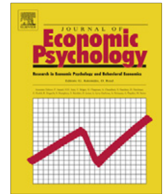

The impact of empowering investors on trust and trustworthiness

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ABSTRACT

This paper uses a controlled laboratory environment and a two-person investment game in a multi-period setting to examine the impact of empowering investors with the right to veto the investee's profit distribution on trust and trustworthiness. Two forms of vetoes are tested: the first is costly for the investor to implement and the second is costless. One of the key findings is that the empowerment of investors through both costless and costly vetoes significantly increases trust by over 30% in both cases. To control for a treatment sequence effect, we conducted the experiment in a reverse order. We observe a comparable loss in trust when the power to veto is removed. Further analysis of veto decisions indicates that empowering investors increases both trust and trustworthiness without an undue abuse of the power to veto and that the veto decisions are mainly driven by unfair responses, consistent with the notion that most vetoes are cast by investors whose trust has been betrayed.

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1. Introduction

Trust is an important driver of investment decisions, especially in bargaining environments such as those related to investments in early stage business ventures and loosely connected business alliances, where contracts are generally between small numbers of agents and are inherently incomplete and difficult to monitor and enforce (Chan, Kensinger, Keown, & Martin, 1997; Rosenkopf & Almeida, 2003). Prior literature documents that several behavioral factors including risk preferences, social preferences and reputation influence behavior related to trust (Anderhub, Engelmann, & Güth, 2002; Bohnet, Greig, Herrmann, & Zeckhauser, 2008; Bohnet & Huck, 2004; Fehr, 2009; Kanagaretnam, Mestelman, Khalid Nainar, & Shehata, 2009). More recently, betrayal aversion is identified as a major inhibitor of trusting behavior (Bohnet et al., 2008; Fehr,

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2009). In particular, there seems to be a special aversion towards being exploited by untrustworthy partners that prevents fully trusting behavior.

Given the above, an important question that should be addressed in the literature is: are there mechanisms which can be used to enhance the level of trust by assuring that the potential power of the parties to a business transaction is balanced so that there is recourse for betrayal of trust? Answering this question is particularly important in situations where business contracts are incomplete and one of the parties has complete control over the decision on the distribution of profits. This control over the distribution of profits introduces the need for assuring a high level of trustworthiness (or reciprocity) on the part of the parties distributing the returns to the investment, for this is likely necessary to induce trust.

The current study proposes and empirically examines the impact of a veto as an explicit mechanism for empowering an investor in a simple repeated investment game. Two forms of the veto are tested. One veto treatment is costly for the investor to implement and the second is relatively costless. We conjecture that introducing the veto mechanisms are likely to enhance the balance of power between the parties of an investment activity, and hence increase their level of cooperation (i.e., increase the level of trust and trustworthiness). With the costly veto, the investor may reject the profit distribution of the investee resulting in both investor and investee receiving a payoff of zero. With the costless veto, rejection results in the investee realizing a payoff of zero, but the investor will retain the initial investment.[1] The vetoes permit the investor to reject the investee's decision and deny the investee any income in the round in which the investee's response is vetoed. The introduction of the veto into a repeated game environment can be seen as a mechanism designed to restore what Kramer (2009) described as the presumptive trust that was tempered (lost) through negative experience or giving the investor recourse for betrayal of trust.[2]

Our laboratory environment closely relates to the organizational forms of alliances and joint ventures described by Chan et al. (1997).[3] In particular, our experiment resembles a business context of a simple two-partner alliance with a dominant partner (who is the investee in our experiment and decides on the profit-sharing rule). The other partner's contribution to the alliance is similar to the investment game's investor (who provides resources to the dominant partner). The synergy from an alliance relationship is captured by the tripling of the investment in our experimental design.[4]

In this study, we focus on the effects of three treatments on a measure of trust and a measure of reciprocity derived from an investment game originally introduced in Berg, Dickhaut, and McCabe (1995).[5] Treatment 1 is a repeated game, during which the participants' roles as investors or investees do not change and the individuals with whom the participants were paired do not change. Treatment 2 is a repeated game with a costly veto and treatment 3 is a repeated game with a costless veto. While trying to account for possible learning effects by reversing the order of our treatments, we are also able to study the loss of trust and reciprocity when the power to veto is withdrawn.

A key finding of this study is that empowerment through an embedded veto option significantly increases trust. Empowerment of investors as implemented (by both the costly and the costless veto) contributes to a substantial increase in trust (over 30% in each case). More specifically, trust (as measured by the level of investment) increased from 71.2% for repeated games to 94.7% for repeated games with costless veto. Interestingly, we observe a comparable pattern when the power to veto is withdrawn, i.e., there is a substantial drop in trust, providing some insights into factors driving lost trust. The consistent trust results for the empowerment of investors and for the withdrawal of the investor's power to veto, indicates that the empowerment findings are not a result of participant learning the game, but a result of incentives inherent in empowerment. Additionally, once a veto is introduced, it is the interaction of the beliefs of the investor regarding the character of the investee with this ability to veto that will ultimately determine the action the investor will take in the punishment stage of the game.

Our results for reciprocity are mixed. Average reciprocity is significantly greater when empowerment is costly than when the veto is absent. However, there is no difference in the level of reciprocity between the costless veto and the costly veto.

In additional analysis, we explore the determinants and the patterns of vetoes cast in our experiment. Although the participants in this experiment had 378 opportunities to cast a veto following the response of an investee, interestingly vetoes were cast only 44 times (less than 12% of possible vetoes). This indicates that empowering investors increases both trust and reciprocity without an undue abuse of the power to veto (without overly destroying social surplus). In the analysis of the determinants of the veto, not surprisingly, the estimated probability of casting a veto is significantly greater under the costless veto than under the costly veto. Additionally, the investor's trust and the interaction of the investor's trust and the investee's reciprocity are highly significant. The risk attitude of the investor is also significant. The significant interaction between trust and reciprocity displayed by the regression results indicates that when reciprocity is low, individuals who dis-

[1] Note that the costless veto is not necessarily without cost, as an investor may reject an amount that may be greater than what was invested, but less than what the investor believes is appropriate. In this case there is a cost to the veto, but it is less costly than the costly veto treatment.

[2] This is comparable to permitting contributors in a public good game to punish non-contributors as a means to promote cooperation (Fehr & Gächter, 2000) and to permitting employers to punish workers who do not honor effort commitments (Fehr, Gächter, & Kirchsteiger, 1997).

[3] Strategic alliances bring together otherwise independent firms to share resources in product design, production, marketing, and/or distribution so as to generate synergy. Such alliances are becoming prevalent as competitive pressures force firms to adopt flexible and more focused organizational structures (Chan et al., 1997). Mutual cooperation in alliances is not automatic because, in the absence of trust, individual firms may be guided by their self-interest both before and after joining an alliance.

[4] Throughout the text we use the term investor for the sender. Similarly, we use the term investee for the receiver.

[5] In this two-person game, an investor sends some amount of a resource endowment to an investee. The investment is grossed up, to capture the return to the investment in the investee's hands, and then the investee sends resources back to the investor. The proportion of the endowment that is sent can be interpreted as a measure of the investor's trust. The proportion of the grossed-up investment that is returned can be interpreted as a measure of the investee's reciprocity, trustworthiness or fairness. We later define trustworthiness and fairness within the context of the reciprocity measure.

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