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Trust in third parties

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ABSTRACT

Independent decision makers are appointed to promote trust by shielding investors from rent appropriation efforts of insiders. We conduct experiments to show how the appointment procedures for such third parties influence the trust of investors and the actual distributions of returns on investment. We find that when the third party is randomly assigned, investments significantly increase in response to positive returns on investment. Investments are similarly high when insiders select anonymous third parties. However, a simple one-sided reputation mechanism between the third party and the insider (but not the investor) diminishes trust and eliminates the benefits of a supposedly independent third party. In a second experiment we show that the trust of investors, evidenced by their investment level, surprisingly does not depend on whether the decision to delegate to an independent third party or not is taken by insiders themselves or exogenously imposed by a random device.

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1. Introduction

A key claim in the corporate governance literature is that firms attract more investments and generate more rents if neutral institutions such as independent board members, auditors, or financial regulators restrict powerful insiders and guarantee property rights (e.g. Shleifer and Vishny, 1997; La Porta et al., 2000). For example, to ensure auditor independence, the European Union including Great Britain introduced new auditing rules in June 2016 that require companies to change their auditor after ten years. In the US, firms are required to rotate the engagement partner primarily responsible for a client's audits after five years. Similarly, entire economies may benefit from independent courts or other nonpartisan institutions like central banks (Schelling, 1960; North, 1981; Knack and Keefer, 1997; Acemoglu et al., 2001).[1] While the suggested

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[1] The World Bank's annual "Doing Business" project reflects this consensus, as do corporate governance codes in the US, the UK, Germany and other countries. The delegation of decision rights to independent institutions is only one of many potential strategies to facilitate trust and encourage specific investments. Fairness concerns (Hackett, 1994; Oosterbeek et al., 2003), promises/threats sending simple text messages (Ellingsen and Johannesson, 2004b, 2004a), and shared ownership rights (Fehr et al., 2008) may also cause individuals to make specific investments even in the absence of known reputations or repeated interactions.

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positive impact of such independent third parties on investments is compelling, it is still unclear what exactly constitutes an independent third party and when people trust a decision maker to be nonpartisan. Furthermore, even when the aggregate benefit of independent third parties is positive, it is unclear whether controlling stakeholders voluntarily delegate decisions to them.

Because we are interested in the underlying behavioral mechanisms, we take an experiment-based approach to addressing these questions. This approach is also warranted because two problems restrict an appropriate empirical identification in the field. First, the identification of independent third parties is difficult. Third party appointment and payment procedures can easily impair independence and may lead to a diffusion of responsibility and biased actions (Fershtman and Gneezy, 2001; Hamman et al., 2010). Powerful insiders have great incentives to tacitly compromise a third party's independence to improve their access to economic rents. A CFO promises a multi-year contract if an auditing firm provides favorable reports. A CEO recommends a person as a board member with whom she has officially no business relations but enjoys an unobserved close private contact. Membership in the same country club may not violate independence regulations, but it can still compromise a board member's independence (Gibson et al., 2013). These informal links also frustrate the efforts of empirical researchers, because they are usually unobservable (Schniter et al., 2013). The second problem is that the empirical identification of the effect of independent institutions on trust is complicated by endogeneity concerns. As institutions and trust are jointly determined, correlations are likely to be confounded by omitted variables.

This paper examines trust in third parties by conducting variations of the repeated investment or trust game established by Berg et al. (1995). In the standard investment game (which serves as a baseline treatment) the receiver represents the powerful insider. She gets the benefits from any investment and decides the size of the back transfer to the investor. In the three third-party treatments that we consider in the first experiment, a third party allocates the benefits between the investor and the receiver. The different treatments vary the appointment process for this third party, who receives a fixed fee for any appointment. We rule out reputation building between the investor and the receiver or third party by using a repeated stranger matching protocol and by not providing the investor any information about the selected third party.

In the first treatment, where the third party is truly independent, having been assigned by a random device, we find that investments significantly increase. In the second treatment, where the receiver selects the third party without having any information on the identity of the third party, investments are similarly high. Interestingly, the benefits of delegating the back transfer decision to a randomly assigned third party or to a selected but anonymous third party only materialize after a few rounds, which indicates that it takes time and positive experiences to establish trust. In the third treatment, where the receiver can select among third parties whose identifiers remain constant, investors invest no more than in the baseline treatment, where there is no delegation to a third party. Revealing the parties' identities to the receivers (but not the investors) activates one-sided reputation mechanisms between third parties and receivers, which decreases proportional back transfers and reduces trust in the third parties.

In a second experiment we endogenize the delegation decision to test how investors respond to deliberate decisions on whether to delegate the back transfer decision to a third party. At the beginning of each round, a receiver in the endogenous treatment has the choice to either determine the back transfer herself or delegate the back transfer decision to a randomly assigned third party. We compare the results with the outcome from an exogenous treatment in which a computer makes a random choice to either leave the back transfer decision with the receiver or delegate it to a randomly assigned third party. Unexpectedly, we find that a deliberate decision by the receiver to delegate does not lead to significantly higher investments than when delegation is exogenously imposed by the random device. Similarly, neither does endogenous non-delegation, the deliberate refusal of the receiver to delegate, significantly decrease investments compared to exogenous non-delegation by the random device. We therefore find no evidence for intention-based reciprocity (Falk and Fischbacher, 2006) between the investor and the receiver.

The paper is structured as follows. In Section 2 we establish the contribution of this paper to the literature. Sections 3–5 present the design, behavioral predictions, and results, respectively, of the first experiment. Sections 6 and 7 present the design and behavioral predictions, and results, respectively, of the second experiment. In Section 8 we discuss implications for theory and practice.

2. Contribution to the literature

Third parties influence both value creation and value appropriation. The strategic value of third parties for *value appropriation* has been analyzed by conducting variations of ultimatum games, dictator games, and punishment games. Fershtman and Gneezy (2001) show that the proposer's payoff in an ultimatum game is higher when the proposer uses a third party who can be incentivized to make unfair offers. This happens because people are reluctant to reject (unfair) offers when both the proposer and the third party suffer a loss. Lammers (2010) argues that principals hire a selfish rather than a fair agent when the benefits of aggressive sales bargaining outweigh the losses from aggressive wage bargaining. Hamman et al. (2010) find that recipients receive significantly less money in a dictator game when principals hire third parties to act on their behalf. Diffusion of responsibility explains this finding: The principals feel less responsible for the outcome when hiring third parties, and third parties feel that they are just following orders. Coffman (2011) and Bartling and Fischbacher (2012) show that delegation is beneficial to principals in allowing them to shift responsibility for unfair allocations. These authors have conducted dictator games with a delegation and punishment option, and find that selfish principals receive less severe punishment if a third party implements an unfair allocation on their behalf.

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