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The competitive advantage of honesty[☆]

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ABSTRACT

We study competitive markets where firms may lie to their workers to reduce costs. Consumers may benefit from firms' dishonesty through lower market prices. Does firms' (dis-)honesty affect consumers' purchasing decisions? Our experiment shows that when honesty is fully transparent, it can provide a competitive advantage: Honest firms sell more and – despite higher costs – achieve higher profits. This finding is in line with our equilibrium predictions when allowing for dishonesty-averse consumers. By identifying circumstances in which consumers – although not the addressee of dishonesty – “punish” firms for their within-firm dishonesty, we contribute both to behavioral ethics and behavioral industrial organization.

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1. Introduction

Consumer social responsibility is “the conscious and deliberate choice to make certain consumption choices based on personal and moral beliefs,” which may be observed as “expressed activity in terms of purchasing or non-purchasing behavior” (Devinney et al., 2006, p. 32). The impact of consumer social responsibility on total consumption decisions and its drawbacks for producers are widely debated issues in consumer research (for an overview, see e.g., Smith, 2007). In recent years, these questions have also been addressed in controlled experimental frameworks. Rode et al. (2008), Etilé and Teyssier (2012), and Feicht et al. (2014), for example, show that consumers are willing to pay (slightly) higher prices to buy a product that implies a donation to an NGO. Bartling et al. (2015) find that consumers accept a price premium for goods that do not harm a third person. The effect of consumer social responsibility in different competition environments is studied in Pigors and Rockenbach (2016). They find no indications for consumer social responsibility when the supplier is monopolistic. In competitive markets, however, when consumers can choose between different suppliers, consumers' purchasing behavior may make socially responsible production profitable for suppliers. These experiments take payoff allocations as a proxy for social responsibility. Although distributional consequences are an important aspect, they are surely not the only

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influence on consumers' "moral beliefs". Apart from possible distributional and legal aspects, the moral component in companies' lack of compliance with, for example, human rights, animal rights, environmental protection, political rights, tax laws, and workers' rights is a prominent aspect in recent discussions of corporate social responsibility and often serves as a trigger for boycott calls by "ethical consumers".

O'Connor and Meister (2008) ask subjects to rank-order different measures of corporate social responsibility, identifying honesty as the most important attribute of a corporation.¹ Yet corporations' (dis-)honesty may have different facets. Evidently, there is dishonesty about product attributes, and not only since VW lied on CO₂ emissions. A prime example features companies exploiting their informational advantage to be dishonest about the product quality and consumers incurring financial losses by buying lower quality than announced. There is an extensive theoretical and experimental literature on asymmetric information in markets (following the seminal paper by Akerlof, 1970) and credence goods (e.g., Dulleck and Kerschbamer, 2006) dealing with situations in which consumers suffer from firms' dishonesty. However, whether consumers' desire for honest firms is (solely) driven by avoidance of personal financial losses or (in addition) by a profit-independent aversion to buying from a dishonest firm cannot be studied in these models since both facets come in conjunction. The aim of our study is to disentangle these two facets of honesty and ask whether consumers value companies' honesty, even if dishonesty does not result in a financial loss for the consumer. To do so we experimentally study two-sided markets, with firms offering a good with a fixed monetary value to consumers at a firm-specified price. Firms may be dishonest to their workers to save wage costs and thus offer lower prices to consumers. Hence, in our model, firms' dishonesty is not towards the consumers but towards a third party (the workers) that is not a trading partner. We investigate whether – and if so under which information conditions on the firms' (dis-)honesty – consumers will take firms' (dis-)honesty into account when trading on the market. The model strongly challenges potential consumers' dishonesty concerns as firms' dishonesty may even be beneficial for consumers in the event that dishonest firms charge lower prices.

We find that honesty is very low when consumers cannot observe a firm's honesty. However, consumers condition their buying decisions on a firm's honesty when it is fully transparent. This effect is strong enough to render honesty a competitive advantage for firms. Honest firms make higher profits by selling more units, albeit not at higher prices. A robustness treatment that separates honesty from fairness concerns demonstrates that this result is driven by honesty and not by consumers' distributional fairness concerns.

Our research not only contributes novel insights to the literature on consumer social responsibility but also to the study of bounded rational behavior in industrial organization (see e.g., Armstrong and Huck, 2010, Spiegel, 2011). To the best of our knowledge, we are the first to study the extent to which a firm's honesty influences consumers' purchasing decisions when consumers are not financially harmed by firms' dishonesty, but may instead benefit from it. In the theoretical analysis of our market model, we analyze the effects of consumers and/or firms having non-standard preferences by being inequity and/or dishonesty averse. By having both market sides interacting in the lab,² we can test our theoretical predictions. We present the novel finding that preferences for buying from an honest firm may play a crucial role in consumers' purchasing decisions. This is particularly noteworthy as it extends our insights on lying aversion. Different from previous research, lying is directed toward a third party and potentially benefits the two trading partners. Nonetheless, we find an aversion to lying sufficient to provide a competitive advantage for honest firms.

2. The market model

In our experiment, we study a bilateral Bertrand duopoly, with two firms A and B and two consumers X and Y . Firms offer a good on the market, consumers may purchase at most one unit of the good, and each firm may potentially serve both consumers. Each consumer has a fixed valuation v for the good (in the experiment $v = 30$). Each firm z consists of a manager M_z and a worker W_z , $z \in \{A, B\}$. The manager determines the price p_z for the units of the good her firm offers (in the experiment $p_z \in \{0, 1, \dots, v\}$) and determines the wage w_z of her worker (for details see below). The worker produces the firm's units of the good.

Before the market starts, a *state of the world* $S \in \{\underline{S}, \bar{S}\}$ is randomly drawn, with both realizations being equally likely. You may think of the state S as a proxy for the production environment of the firm. A firm's worker does not know the exact production environment, i.e., the realization of S , yet provides a guess \hat{S} for S . The accuracy of the worker's guess determines the production costs c that he entails for his firm. If a worker guessed right ($\hat{S}=S$), the worker entails low production costs c_1 for his firm (in the experiment $c_1=0$). Otherwise, if $\hat{S} \neq S$, the worker entails high production costs $c_0 > c_1$ for his firm (in the experiment $c_0=6$). You may interpret the accuracy of the guess as a proxy for the worker's ability: a worker who guessed the unknown production environment right e.g., by having acquired the appropriate education, is of "high ability" and thus entails low production costs.

The firm's manager has complete information on the production environment and the worker's guess, i.e., knows both S and \hat{S} . The manager informs her worker whether he guessed right or wrong, i.e., sends information $I \in \{\text{guessed right}, \text{guessed wrong}\}$.

¹ "I think a corporation should be honest" ranked higher than "produces quality products and services", "treat employees fairly", "give back to the community through philanthropic activities" and "conduct business in an environmentally friendly manner".

² Kalayci and Potters (2011) and Huck et al. (2016) also investigate bounded rational behavior in the interaction of consumers and firms in experimental market studies.

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