



Intention-based reciprocity and the hidden costs of control



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ABSTRACT

Empirical research suggests that – despite strengthening conventional incentives to put in effort – exerting control might reduce worker performance. The present paper shows that intention-based reciprocity can explain such hidden costs of control if individuals differ in their propensity for reciprocity and preferences are private information. Not being controlled might then be considered to be kind, because not everybody reciprocates not being controlled with high effort. This argument contrasts existing theoretical wisdom on the hidden costs of control that is almost exclusively based on signaling.

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1. Introduction

There is a wide-spread belief in human resource management and the popular business press that exerting control can damage worker performance by eroding motivation and willingness to cooperate.¹ This view is consistent with numerous empirical studies from psychology and organizational economics.² In their prominent study [Falk and Kosfeld \(2006\)](#) investigate such hidden costs of control in an experimental work relationship. Workers can exert costly effort to increase the payoffs of their bosses. Before workers choose effort, bosses decide whether or not to control workers. Imposing control forces workers to exert at least some minimum effort. If workers maximize their own payoffs, they exert the least effort possible to save on effort costs. Falk and Kosfeld find that although many workers indeed always choose the least effort possible, a substantial fraction of workers exert less effort if controlled than if not controlled. Exerting control in fact reduces average effort contributions.³

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¹ See, for example, [Manzoni and Barsoux \(1998\)](#) and [Herzberg \(2003\)](#) who stress the negative consequences of exerting tight control over employees. [Foss \(2003\)](#) provides a careful case study on the detrimental effects of such micro-management.

² The extensive empirical literature on monitoring and motivational crowding-out includes [Plant and Ryan \(1985\)](#), [Barkema \(1995\)](#), and [Dickinson and Villeval \(2008\)](#). Further, [Enzle and Anderson \(1993\)](#), [Ariely et al. \(2008\)](#), and [Dominguez-Martinez et al. \(2010\)](#) show that individuals dislike being controlled, and do not dislike being monitored as such. Together these studies document the existence of hidden costs of control. [Ryan and Deci \(2000\)](#) and [Frey and Jegen \(2001\)](#) discuss some theoretical foundations for hidden costs of control, and they provide numerous additional references.

³ Although there is some debate in the literature concerning the magnitude of the effect, an increasing number of studies provide experimental evidence for the existence of hidden costs of control. See in particular [Schnedler and Vadovic \(2011\)](#) and [Charness et al. \(2012\)](#).

Since choosing high effort remains feasible even when being controlled, such hidden costs of control are incompatible with transitive preferences defined exclusively over payoff outcomes. Theoretical economic explanations for the observed behavior are therefore almost all based on signaling models.⁴ However, these explanations can only be relevant if firms have some informational advantage over workers. This is not reasonable in all the circumstances in which there exist hidden costs of control. The present paper complements the existing literature by showing that intention-based reciprocity can be an alternative explanation for hidden costs of control. This new explanation is not based on signaling.

The present analysis further qualifies the wide-spread opinion that intention-based reciprocity is inconsistent with hidden costs of control. At first it might seem very natural to think that workers consider the mere act of not being controlled as kind, and then reciprocate not being controlled with high effort. Yet Falk and Kosfeld (2006, p. 1616) rightly argue that this is inconsistent with existing models of intention-based reciprocity. The reason is that exerting no control has to be considered unkind if uncontrolled workers exert higher effort and thus receive lower payoffs than controlled workers. In other words: if everybody expects workers to always reciprocate not being controlled with particularly high effort, then not exerting control is no longer kind because it reduces the payoff of workers, and thus cannot trigger high effort as reciprocal reaction.

The present paper shows that – with a simple extension of the basic model – intention-based reciprocity can explain hidden costs of control. The only requirements are that individuals differ in their propensity for reciprocity, and that preferences are private information.⁵ After exploring the proposed extension in a more general setup, the model considers a simplified version of the control game from Falk and Kosfeld. The key assumption is that some workers are purely selfish in the sense that they only care for their own monetary payoffs, whereas other workers are reciprocal in the sense of Rabin (1993) and Dufwenberg and Kirchsteiger (2004). They are thus willing to incur some monetary costs to reciprocate kind actions with kind actions. Preferences are private information. The analysis shows that if reciprocal workers are sufficiently reciprocal and the fraction of selfish workers is sufficiently high, there exists a pure-strategy reciprocity equilibrium in which (i) selfish workers always choose the minimum feasible effort, whereas (ii) reciprocal workers choose lower effort if controlled than if not controlled.

This equilibrium is based on the following intuition. On the one hand, exerting no control would be unkind if all workers were reciprocal, because then all workers would reciprocate no control with high effort. On the other hand, exerting no control would be kind if all workers were selfish, since then all workers would shirk and consequently get high payoffs. For the existence of the above reciprocity equilibrium, it is thus crucial that workers' preferences are not only heterogeneous but also private information. In this case bosses do not know their workers' preferences, and workers know that bosses do not know their workers' preferences, thus workers must form beliefs concerning the kindness of their bosses' actions. For this they put themselves into the shoes of their bosses, taking into account only the information that bosses actually have when taking their control decisions. Workers thus derive the average kindness of particular actions. If most workers are rightly expected to be selfish, reciprocal workers might consider it to be on average kind to be left uncontrolled. Reciprocal workers consequently reciprocate not being controlled with high effort.

It is important to note that exerting no control is not considered to be kind by reciprocal workers because it provides other selfish *colleagues* with the opportunity to shirk. Workers have no colleagues in the considered situations. Instead, workers take into account that their bosses rationally believe *them* to be predominantly selfish! Exerting no control is therefore considered to be kind because (i) it provides also reciprocal workers with the opportunity to get a high payoff by shirking, (ii) this opportunity is not purely hypothetical, since everybody knows that most workers shirk if not controlled, and (iii) bosses do not know workers' types, and thus risk getting low payoffs by forsaking control. In essence, not controlling workers is kind, exactly because this kindness might not be reciprocated.

For illustration of the underlying theoretical mechanism, consider the following example. Suppose a new acquaintance visits your home for dinner. Social convention requires the guest to bring a bottle of wine. Unfortunately, your new acquaintance does not know your preferences concerning white or red wine, and you are aware of this ignorance. It is also commonly known that people typically prefer red wine. But you actually prefer white wine. Would you consider your guest bringing red wine as unkind? The present model would argue that bringing red wine is – given the incomplete information on your preferences and prior beliefs – actually kinder than bringing white wine. This holds even though you actually prefer white wine.

The following example further illustrates the importance of incomplete information for the argument. Suppose an employer decides to provide all male workers with a pay rise, while keeping the pay for female workers unchanged. Could this be considered as on average kind by female workers, if the vast majority of employees is male? After all, every worker had a 50% chance of being male at birth. According to the present model, the answer is negative, because gender is observable. Every female worker thus knows that denying a pay rise to female employees is unkind to her, because the employer knows her gender, and therefore knows exactly the unkind consequences of his decision on her pay.

⁴ The related economics literature is discussed at length in Section 2.

⁵ The empirical evidence clearly shows that individuals differ in their reciprocal or social preferences. See, for example, Fischbacher and Gächter (2010). Heterogeneity is also an important theoretical component in other model of social preferences. For example, Fehr et al. (2008) and Fehr and Schmidt (2000) show that inequity aversion à la Fehr and Schmidt (1999) is consistent with the laboratory evidence only via the strategic interaction between selfish and inequity averse individuals.

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