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Morality in the market☆

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ABSTRACT

Being honest can be a competitive disadvantage. In markets with the opportunity to violate laws and regulations, producers who are willing to cheat may crowd out more efficient producers who are honest, and buyers who are willing to cheat may crowd out honest buyers with higher willingness to pay. This mechanism makes morality (honesty) a bad substitute for sanctions in markets. Honesty reduces cheating, but the output may be less efficiently produced and less efficiently allocated among buyers. I also show that the effect of honesty depends crucially on the fraction of honest traders among both buyers and sellers. While it does not matter whether a buyer or a seller pays the sanction, it does matter who is honest.

1. Introduction

Can a desirable trait such as honesty become a social cost in a market economy? Good morals, such as honesty, may prevent people from cheating on laws and regulations, just like an effective sanction. As enforcing laws and regulations by sanctions alone is expensive, there is a growing interest in morality as a potential substitute for sanctions. I claim that even if morals can substitute for sanctions at the level of individual transactions, they cannot substitute for sanctions in markets where prices, entry and exit are endogenous. Morality affects market outcomes, but these outcomes cannot be predicted on the basis of simple analogies between moral costs and pecuniary costs.

I define an honest seller or buyer as one who follows laws and regulations even when it pays to cheat, and discuss the effect of having more honest sellers or buyers in a market. Below, I demonstrate how such honesty among sellers can reduce efficiency of production and honesty among buyers can reduce efficiency of exchange. To see this, consider a market where all producers cheat on safety regulations to save costs. Cheating means their private costs of production are lower than the social opportunity costs, which means output is too high. Still, as long as all producers cheat, output is produced by the most efficient ones, as the ranking of private and social costs of production are the same. This is not the case if some producers

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are honest and others not. A producer who cheats has lower private costs than an equally efficient but honest producer. As honest producers may be crowded out by less efficient producers who are willing to cheat, output is inefficiently produced.

This example illustrates the key difference between sanctions and morality in the market. As sanctions are the same for all, they do not change the ranking of private costs of production. Two producers with the same social opportunity cost of production also have the same private cost. Morals, however, differ between the individuals, which means they change the ranking of private costs of production. Two producers with the same social opportunity cost may differ in their private cost. This implies that honest producers who exit may be replaced by less productive producers who cheat. When entry and exit in a market is determined not only by productivity, but also by the willingness to cheat, competition is distorted.

In a market with few honest producers, those who exit when they become honest are most likely replaced by dishonest ones who are less efficient. In a market where most producers are honest, however, they are most likely replaced by honest ones who are more efficient. Thus, improving honesty among sellers has a more favorable impact in markets where most producers are already honest. Thus, the efficiency of production varies with the fraction of honest producers. A key result is that a higher fraction of honest producers reduces efficiency of production in a market with a low fraction of honest producers but improves it in a market with a high fraction.

Even if the seller is the one responsible for complying with laws and regulations, the morality of the buyer matters if he can verify whether or not the seller complies. As an honest buyer will only trade if the seller complies, he increases the cost for a seller who would otherwise cheat. An honest buyer may therefore be charged a higher price than one who accepts cheating. As a result, honest buyers may be crowded out by buyers who have a lower willingness to pay but accept cheating. I show that in the case with honesty among buyers but not among sellers, the crowding out leads to inefficient allocation of output among buyers, but output is efficiently produced. This points to another difference between sanctions and morals: with pecuniary sanctions, it does not matter whether it is the buyers or the sellers that are sanctioned. With the intrinsic sanction from morality, it does.

Varying the fraction of honest buyers and sellers gives rise to different types of equilibria. For example, in an equilibrium with many honest sellers, but few honest buyers, more honesty among buyers does not affect the market outcome, while more honesty among sellers does. Many honest buyers, but few honest sellers, gives the opposite result: More honesty among sellers has no effect, while more honesty among buyers does. With more equal prevalence of honesty in the two groups, more honest buyers may improve efficiency of production but reduce the efficiency of exchange. If these complex effects of moral differences in markets are not recognized, policies to improve morality may have no effect or even be harmful.

Policymakers have embraced the idea that inexpensive framing and appeals can "nudge" people to comply. One prominent example is the UK Cabinet Office Behavioral Insights Team (2012). Insights from behavioral economics suggest that morality plays a role in individual economic decisions. Most people are for instance willing to sacrifice some economic gains for being honest and fair.[1] As higher sanctions may be both expensive and politically unpopular, moral suasion seems like an attractive substitute.

The effect of policies to influence morality is less well studied, and the results are mixed. Mazar et al. (2008) report that dishonesty goes down when people have to think of the Ten Commandments or cite an honor code before taking a test with an opportunity to cheat. In a public contribution game experiment, Dal Bo and Dal Bo (2014) find a transitory effect of moral suasion. In a randomized field experiment, Blumenthal et al. (2001) find that letters to taxpayers with moral appeals have no effect, while Bott et al. (2014) find large effects in a similar experiment. While these studies suggest that policies to influence honesty may work on individuals, they cannot be used to infer the effects of honesty in markets. I show that there is no simple relationship between the effect on an individual's compliance and the effects in the market. In particular, policies that make more individuals compliant may not improve the market outcome.

The literature on morals and sanctions in the market has focused on how sanctions may crowd out moral motivation in individuals by reducing its value.[2] The opposite problem of how lack of sanctions may crowd out productive but morally constrained agents, has received less attention. The novelty in my framework is to explore how sellers and buyers reduce the private costs of holding a moral standard by exiting markets where this standard is a competitive disadvantage, and to demonstrate how these exits create inefficiencies for society.

My use of the term "honest" differs from that in the literature on honest (or "naive") versus strategic traders, such as Saran (2011) and Severinov and Deneckere (2006). In these papers, an honest trader is one who tells the truth about his type, such as the cost of producing or the willingness to pay, in contrast to a strategic trader who may misrepresent his type. In my paper, there is full information about type. An honest trader is one who abide by laws and regulations, while an opportunistic trader cheats on laws and regulations if it pays to do so.

Section 2 presents the model of a market with opportunity for tax evasion, and derives the effects of honesty among sellers. The buyers do not know about or do not care about whether the seller evades or not. In Section 3, I discuss the effect of honesty among both buyers and sellers, assuming that a buyer can verify if his payment is reported or not. I first demonstrate that honesty among buyers in a market with no honest sellers, gives a different result from honesty among

[1] See for example Camerer (2003), Cappelen et al. (2007), Fehr and Schmidt (1999), Fehr and Fischbacher (2002), Fehr and Gächter (2000a), Fehr and Gächter (2000b) and Fisman et al. (2007).

[2] See Gneezy and Rustichini (2000), Brekke et al. (2003), Fehr and Rockenbach (2003), Benabou and Tirole (2006, 2011) and Ellingsen and Johannesson (2008).