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Exercising empowerment in an investment environment☆

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ABSTRACT

Using data from a laboratory-controlled environment we analyze the decisions of principals to veto the allocations of grossed-up investments proposed by their agents in a modified trust game. Using probit analysis, we find that the trust displayed by the principal and the trustworthiness of the agent are statistically significant variables in estimating the likelihood that a principal will exercise a veto and that the notion of fairness is important in explaining veto decisions. We also analyze the surpluses before and after the exercise of vetoes and find that potential surpluses rise with the introduction of empowerment. However, actual gains are not different from those realized in environments in which principals are not empowered. This result is qualified by the recognition that the number of decision rounds that are played by the participants in this experiment may not be sufficient for the full effect of empowerment to be realized.

1. Introduction

Trust is an integral component of economic interactions between two parties. Trust and reciprocity (trustworthiness) have been studied in the game-theory literature exploring the roles of reputation and repeated games (Cripps et al., 2007), as well as in business research (Kanagaretnam et al., 2010; Lui et al., 2006; Rohm and Milne, 2004).

Prior studies in economics and social psychology demonstrate that betrayal aversion, inequity aversion, altruism, and fairness are important factors that explain human cooperative behavior and can have different effects on individuals propensity to trust and reciprocate in economic and social interactions (Aimone and Houser, 2013; Aimone et al., 2014; Bohnet et al., 2008, 2010; Hong and Bohnet, 2007; Falk et al., 2008; Fehr, 2009; Fehr and Rockenbach, 2003; Fetchenhauer and Dunning, 2012; Tricomi et al., 2010). For example, ceteris paribus, in the presence of uncertainty or incomplete information, betrayal aversion is expected to inhibit investors' trust, which in turn may trigger their agents to lower their rates of reciprocation. In

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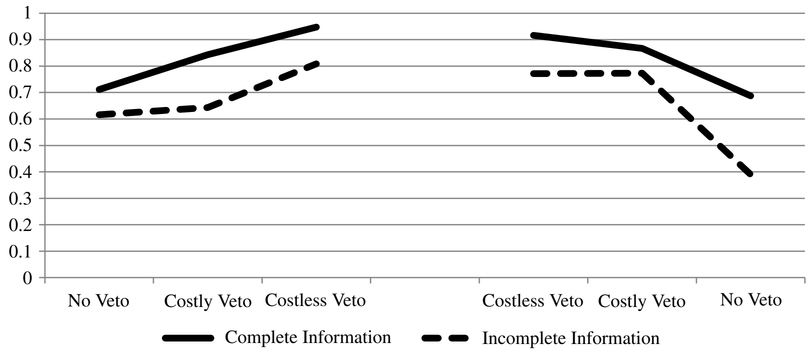

Fig. 1. Average trust by sequence, information condition and veto treatment.

particular, there seems to be a special aversion towards being exploited by untrustworthy partners who behave opportunistically that inhibits fully trusting behavior. Also, it can be argued that, all other things held constant, inequity aversion and altruistic behavior may act as counter factors which are likely to induce cooperative behavior and increase the rates of trust and reciprocity. Consequently, it is difficult to develop a directional expectation about the net effect of the above-discussed human behavior on trust and reciprocity.

In an attempt to investigate the effects of betrayal aversion on trust, Kanagaretnam et al. (2014) provide evidence from a controlled laboratory environment of the effects on trust of permitting principals to punish agents in a simple investment game. Punishment is implemented by permitting an investor (the principal) to veto the decision of a trustee (the agent) on the distribution of the proceeds of an investment rather than accept what the principal believes is an undesirable distribution. Trust is measured as the proportion of the principal's endowment invested and trustworthiness is measured by the proportion of the tripled investment that is returned by the agent. In particular, allowing principals to exercise vetoes offers them unconditional power to punish, thus giving them recourse in the presence of untrustworthy responses—this should in theory alleviate concerns of betrayal and encourage the maximum level of trust.

Kanagaretnam et al. (2014) implement a version of the standard Berg et al. (1995) two-person investment game in a laboratory environment using a repeated-game context with multiple treatments within two information conditions. The information conditions reflect different degrees of transparency with respect to the knowledge that principals and agents have of one another's resource endowments. They conjecture that, all other things being equal, empowering principals with the right to veto their agents' distribution decisions is expected to motivate higher levels of cooperation between parties of economic transactions through stimulating higher rates of trust and reciprocity. They examined two levels of vetoes: costly and relatively costless.[1] This is different from the environment developed by Fehr and Rockenbach (2003) in which principals must announce to agents whether or not they will enforce a costless (to the principal) fixed penalty if the agent fails to return a pre-announced desired distribution.

Their results indicate that when a principal is empowered by being able to penalize an agent who may not act in a way the principal believes is in the principal's best interest, the level of trust and investment increases over that which is realized in the absence of empowerment regardless of the degree of transparency. In transparent (complete information) environments the effect of empowerment is about the same regardless of whether empowerment is introduced or removed. However, in opaque (incomplete information) environments, the loss of empowerment has a substantially greater negative effect on trust than the positive effect associated with the introduction of empowerment. The effects of empowerment and information on trust and trustworthiness (reciprocity) are summarized in Figs. 1 and 2.

Kanagaretnam et al. (2014) do not provide analyses of the principals' decisions to accept the distributions of grossed-up investments made by their agents, the likelihood that a veto will be cast or the change in social and actual surpluses associated with the introduction of empowerment. This report fills this void by providing conjectures regarding the likelihood that vetoes will be cast based on measures of the cost of the veto, the transparency of the decision environment, the risk attitudes and social value orientations of principals and the trust and trustworthiness of principals and agents. The effects of exercising vetoes on the social surplus created in these simple investment environments are also examined.

Using the data from Kanagaretnam et al. (2014), the analysis of the vetoes demonstrates that vetoes are not significantly related to the costliness of the veto, the transparency of the environment, the risk attitudes of the principals or their social value orientations, but they are significantly related to the principal's trust and the agent's

[1] One veto treatment is costly for the principal to implement and the second is relatively costless. With the costly veto, the principal may reject the profit distribution of the agent resulting in both principal and agent receiving a payoff of zero. With the costless veto, veto results in the agent realizing a payoff of zero, but the principal will retain the initial investment. Note that the costless veto is not necessarily without cost, as the principal may reject an amount that may be greater than what was invested, but less than what the principal believes is appropriate. In this case there is a cost to the veto, but it is less costly than the costly veto treatment.