FAIRNESS AND RECIPROCITY OF CONSUMERS

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Abstract

Behavioral economics have provided insights about consumer behavior in a way that can help us understand consumer preferences and decision making in a better way. Standard economic theory assumes that people make economic choices on the basis of perfect self-interest. This simplifying assumption is useful to understand the concept of economic utility. However study of social preferences through the lens of behavioral economics and psychology points out that people do value the fairness of outcomes for others. They also reciprocate by punishing or rewarding the economic agents with whom they transact, even if they have to incur costs for this reciprocity. This paper highlights fairness perception and other regarding preferences of consumers and economic agents through thought experiments. There are four findings that the authors present in this paper. First: People empathize with the loss making economic agents and are willing to incur costs to transact with them. Second: Fairness perception of consumers gets modulated by the urgency of the need. Third: Consumer's expectation of positive reciprocity increases with the strength of loyalty with their suppliers. Fourth: Stability of prices and wages is appreciated by people.

Key words : *Fairness, reciprocity, social preferences, consumer ecosystem, consumer preference, empathy, customer markets, labor markets*

Evaluation of economic outcomes is done by people as gains and losses relative to some reference point with more sensitivity towards losses than towards gains *(Kahneman & Tversky, 1979*). It has been shown that previous transactions between consumer and producer provides reference level of consumer surplus and producer profit to which the consumer and producer are entitled respectively (Dual Entitlement). Fairness of the economic outcome of the transaction are judged based on these entitlements,(*Kahneman, D., Knetsch, J. L. & Thaler, R., 1986).* It can be observed in day to day economic transactions, especially in those economies where business transactions are not well protected by law, that firms avoid using legal recourse in case of disputes due to complexities and waste of time. Implicit fairness norms often govern business relationships and prevent people from being unfair to others because they want long term relationships which are key for survival in competitive business environment. How these social norms gets established is a complex phenomenon and difficult to understand. Business transactions are usually strategic wherein firms having long term vision and plans. Social preferences in strategic relationships can have significant role for aggregate social and economic outcomes, (*Fehr and Gächter, 2000, Camerer and Fehr, 2006).* Ultimatum games experiments have shown that it is not only firms that have strategic orientation but people act strategically in decision making and are averse to inequity. The aversion is not only towards disadvantageous inequity but also towards advantageous inequity, (*Fehr, E. & Schmidt, K. M. 1999).* One possible reason for aversion towards advantageous inequity is that people do not evaluate individual utility in isolation but evaluate utility of the community or ecosystem in which they exist. Being fair is crucial for a healthy community and long term survival of the individual which is part of the community. The present paper discusses how fairness perceptions affect economic decision making of consumers. The paper is divided into four sections, each section presents a finding and evidence supporting the finding. Research methodology used in the paper is thought experiments.

1. Empathy towards loss making economic agents and willingness to incur costs to transact with them

Rational decision making model and the concept of utility is built on the assumption of perfect self-interest of homo economicus. However many social preference studies in Behavioral Economics have provided sound evidence that people exhibit other regarding preferences and they care for fair behavior. They also incur cost to punish unfair behaviors and prefer fairness not only for themselves but for others too. In this section the authors show that consumers are able to empathize with the losses incurred by theirsuppliers. They are also willing to incur costs to keep transacting with them which may be treated as an evidence for the empathy.

Consider the following thought experiment.

1.1 You have two sources to procure vegetables for your daily consumption

A. Many small scale vegetable vendors by the street sideforming a small market

B. A supermarket in your locality

Prices of vegetables in the supermarket are lower by around 10% compared to that offered by the unorganized small scale vegetable vendors. (You come to know from the local newspapers that the supermarket is selling the vegetables at a loss to compete with the vegetable vendors).

Where will you prefer to buy the vegetables from?

N = 98

A)	Small scale vegetable vendors	60	(41)
B)	Supermarket	38	(57)

In the first frame of the above question, even though offered a 10% discount, people (61.2%) prefer to buy from small scale vegetable vendors. In India mostly these vendors are below poverty line people. The preference for buying from these vendors may be due to empathy of people for the needs of these vendors for sustaining their livelihood. In the second frame it is explicitly mentioned that the supermarket suffers losses due to the offered discount. In this frame the preference gets reversed and 58.1% of people prefer to buy from supermarket. Since the supermarket is suffering loss, people prefer to buy from supermarket so that they can support the supermarket. In the first frame the small scale vegetable vendors were less powerful and in the second frame the supermarket was weaker. People's fairness and social utility function may consider supporting the weaker of the economic agent.

Consider another thought experiment

1.2 Three suppliers A, B, C supply same product X at same price INR 10,000 per product to you

They all depend only on you for their business and survival. (Due to rise in labor costs at its geographical location, the production cost of A has risen and it is beyond its control). [Due to wasteful use of resources and mismanagement of funds, the production cost of A has risen]. So firm A had to increase the price to INR 12,000.

On yearly basis you need 120 unit of product X and you used to buy 40 units from each of the firms A, B and C. Now considering the scenario of increased price by A. What would be your preferred number of units you wish to buy from A, B and C

N=98

A : B : C

a.	40 : 40 : 40	(25)	[25]
b.	20 : 50 : 50	(67)	[30]
c.	0 : 60 : 60	(6)	[43]

It is clear that due to the increase in prices by A, the firm will incur costs in case it still decides to buy from A at INR 12,000/- instead of INR 10,000. Still in both the frames significant number of subjects (93.8% in first frame, 56.1% in the second frame) responded to buy at least some number of units from A. However in the first frame, the increase in the cost of the product is not in the control of the supplier. So here very few subjects want to stop transaction (6.1%) and show willingness to continue to buy either as before or reduce the quantity bought, but wants to continue the relationship with A. However in the second frame wherein people come to know that the cost escalation is due to a factor that is in control of the supplier and thereby would have been controlled.A significant number of subjects (43.8%) prefer to stop buying from such inefficient supplier and they do not consider it to be their responsibility to support such a vendor. The responses thus highlights other regarding preference of economic agents. Customers require products for their needs and look for firms who can supply so that their needs are fulfilled. On transacting with the customer, the supplier becomes a part of consumer's ecosystem. In this ecosystem firms enter and exit depending on the fairness perception of the consumer. The consumer is willing to give the fair and positive entitlement (profits) to the firms as they want them to remain healthy and keep offering products to fulfil her needs. The empathy towards loss making entity can be reasoned as a need of the customer to maintain choices by avoiding the elimination of the supplier which incurs losses.

2. Primacy or urgency of the need and perception of fairness

It has been shown that people treat opportunistic selling as unfair, (*Kahneman, D., Knetsch, J. L. & Thaler, R., 1986).*When there is a shortage or a sudden rise in demand compared to supply, there is an opportunity for the firm to exploit this shortage by increasing the price and maximize its profits. As per standard economic theory this is perfectly fine, and it should happen this way. But such exploitation is judged as unfair according to the fairness norm of society or community. This causes a resistance to increase in prices or in case of employers a decrease in wage and thereby causing sluggishness/stickiness in prices and wages,*(Akerlof 1979; Solow 1980; Okun 1981)*. People tend to value entitlements/contracts and any violation to their entitlement is coded as unfair.*Kahneman, D., Knetsch, J. L. & Thaler, R. (1986).*However the contracts are not only legal but also psychological or social and are implicit. These social norms or implicit contracts needs to be respected or else it may affect negatively the goodwill of the firms, which is a key ingredient of sustainable business.

In the present paper author links such fairness perceptions with the primacy or the urgency of the need. To further elaborate the viewpoint, consider the following thought experiment.

2.1 There is a local firm supplying tents for use in picnics and adventure, selling at the rate of INR 500 per m^2 of material. Recently there have been floods in Kashmir, lot of people became homeless and they needed tents for temporary stay until the government makes arrangement. (One of your relative is also trapped in the floods). The tent manufacturer increased the price to INR 1000 per m^2

Rate this action of the tent supplier

N = 98

a.	Completely Fair	4	(4)
b.	Acceptable	12	(41)
c.	Unfair	60	(31)
d.	Very Unfair	22	(22)

Here the need is primal, which is need for survival during a natural calamity. This need is critical but the criticality is intensified in the question by asking the subjects to imagine other but unrelated people in the situation of the floods against imagining their relative in the situation. As per the responses, though people feel the opportunistic pricing of the supplier as unfair, the willingness to pay (as reflected by the Acceptance label) increases significantly in case of second frame. As the criticality intensifies from the first frame to the second frame, people view the overpricing as more acceptable. In the first frame 12.2% people consider the rise as acceptable, in the second frame 41.8% of people label the increase in price as acceptable. Imagining one's own relative in the flood makes the need for tents more urgent and critical. Hence they realize the increase in price as more acceptable considering the situation and let the market clear more easilywhich is as per the standard economic theory.Another way to view the point is that if choices become constrained and need becomes salient, people start compromising on the implicit fairness norms. So the fairness perception gets modulated by the urgency of the need.

3. Expectation of reciprocity in case of long term economic relationships

When a consumer frequently buys products from the same supplier, it is known as customer loyalty in marketing parlance. We can also view this phenomenon as a psychological ecosystem of the consumer. A consumer has many firms /

economic agents in her psychological ecosystem. More loyal the customer to the firm, more close the firm is in the ecosystem. Firms whose mind share is negligible will be far away from the consumer in her psychological ecosystem.

One of the finding of the paper is that more loyal a consumer to her supplier, more will be the expectation of fairness and reciprocity that the supplier should exhibit towards her.

Consider the following thought experiment.

3.1 Its summer vacation time and people are travelling a lot. So availability of railway tickets is a problem. (You book railway tickets via one of the many of travel agents, depending on their availability.)[Since last 10 years you book all your travel ticket through the same travel agent]. On an average the agent has been charging INR 200 per ticket, but due to the season now asks for INR 400 per ticket

Rate the action of the agent as

N = 98

a.	Completely Fair	(23)	[11]
b.	Acceptable	(45)	[27]
c.	Unfair	(24)	[52]
d.	Very Unfair	(6)	[8]

In the first frame people are more acceptable to the increase in charges of the travel agents realizing the demand supply gap. 68.0% of people consider the opportunistic pricing of the agents as either completely fair or acceptable. However in the second frame where they have a relationship with a particular travel agent since last 10 years thereby sharing a loyal relationship, people perceive increase in charges by her to be unfair. Around 61.2% of people in the second frame label the opportunistic increase in commission charges as either unfair or very unfair. This may be because of the raised expectation of reciprocating with fairness due to the long term loyal relationship shared with the agent. As the person has become integral part of the psychological ecosystem of the consumer through a long term economic relationship, her asking for a higher price is termed as unfair. This also points out that in circumstances of unfair treatment by those suppliers to whom consumers are loyal, consumers may punish by breaking the relationship and finding new suppliers. Hence loyal customers are like double edged swords. If they are treated well and entitled to their consumer surplus, they are happy and will stay. But if their fairness perception is disturbed by violating the entitlement without a sound basis or miscommunicating the basis, they will tend to punish by walking away from the loyal customer base.

4. Importance of stability of prices in consumer market and wages in labor market

It has been shown by many authors that wages are sticky and firms are reluctant to reduce the wages during recessions. This sluggishness of wages has been attributed to resistance of firms to disturb the morale of the employees as it may affect the productivity adversely, (Akerlof 1979; Solow 1980). In case of customer markets also even though there are markets and circumstances where the firms are in a monopolistic positions but still are unable or are reluctant to raise the prices as they feel it is detrimental for the long term profits of the firms considering consumer may label such price rises as opportunistic and thereby unfair,*(Okun, 1981)*.Firms do not charge higher prices due to concern for goodwill among their customers and treat the costs as investment in goodwill. *(Akerlof, 1980, 1982).* As for example after almost 15 years Yanni is coming to India for performing and the tickets are being sold at INR 5000 (basic) amidst huge demand compared to constrained supply. Though there is clear opportunity to increase the prices and thereby profits, the organizers do not implement such pricing strategy as auctioning the tickets. Similar is the case during cricket matches in India.

Firms do have sensitivity towards fairness perception of the consumers and their actions are guided by implicit fairness norms of the consumer. It seems such sensitivity towards fair prices is one of the essential characteristics of a firm with long term vision. Incomplete adjustment in the consumer and labor markets suggest that there are constraints to these adjustments. In the present study, the authors carry out a thought experiment, where they try to give a possible alternative explanation for the stickiness observed in wages and prices. Consider the following two thought experiments, the first one for understanding stable prices and the second one for stable wages.

4.1 Consider two firms manufacturing a certain type of cookies. Production costs and MRP of both the firms are same.

Company A frequently varies the MRP of the cookies depending on the rise and fall of input / production costs, even if these are small changes.

Company B tries to maintain stable prices, absorbing small costs during rising production costs and enjoying small profits during reducing production costs.

As a consumer which firm you feel has a better approach towards setting MRP prices?

N = 98

A) 47

B) 51

4.2 Consider two firms offering a wage of INR 200 per day to its workers.

Company A frequently varies the wages of the labor depending on the growth scenario. During good demand of its product, it increases the prices while during lesser demand it reduces the wages. There are no long term contractual arrangement.

Another Company B has a different approach. It has long term contracts with laborers and maintains a fixed wage over 5 year period, irrespective of the industry growth or slump / recession.

Which firm you feel has a better approach towards wages?

N = 98

A) 35

B) 63

In case of the first question, as per the standard economic theory, prices should adjust quickly with the changes in input costs and demand supply gap. However as per the responses, significant number of people (52.0%) value stable prices. Varying the prices frequently has its own costs and complexities for the firms as well as consumers. Larger the size of the firm, more complex it is to vary the prices frequently. From the consumer's standpoint it is also difficult for a consumer to evaluate the fairness of prices which vary frequently. This is because the reference level of consumer surplus and producer profit which is used to evaluate fairness becomes dynamic, which brings ambiguity to the consumer. Such ambiguity is aversive and consumers prefer stable prices.

In case of labor market, stable wages are preferred more clearly than frequently varying wages. 64.2% respondents feel the approach of Firm B of stable wages to be more appropriate. It seems that closely linking the wages with market is not a good idea as certainty of income has its own value. The predictability helps the workers to manage their home finances. Hence many firms have contractual arrangement with laborers for stable wages for contract periods which workers accept.

Discussion : The derivation of aggregate demand and supply curves determine prices. The concept of equilibrium and market clearing in Economics is a very useful tool for understanding customer markets. Firms use this information for the pricing decisions. However customer and labor markets do not always clear as there are constraints which have basis in individual and social psychology. We may also call these constraints as modulators of equilibrium as these factors modulate the equilibrium prices/wages. A consumer is an individual and she has relationships with her suppliers for her needs. The set of suppliers forms a consumer ecosystem within which a consumer transacts. Firms enter and exit depending on certain factors. One of the important factor is the utility that the consumer derives from economic transactions. However this utility is not individual or isolated. It is highly interdependent relationship. This is where the utility becomes social rather than individual. From this interdependent needs fairness norms may have emerged which govern economic transactions between consumers and firms. These norms are implicit and are not enforceable by law but acts as guiding force for economic transactions.

Trust in economic transactions can have significant consequences for the consumers. Such trust is limited and people are skeptical of the behavior of the other during economic transactions. To counter this distrust in a cost effective manner, fairness norms gets evolved overtime. Such norms may have cultural influences. People are willing to incur costs by reciprocating positively or negatively in order to protect these fairness norms, thereby directing the behavior of people around them towards fairness. How these fairness norms and the perception of fairness gets changed is important to understand as it decides the reciprocity of the consumers.

Conclusion : What decision a firmtakes when an opportunity arises to raise the price has important aggregate economic consequences due to established fairness norms of consumers. Historical prices acts as reference price and consumers and firms are entitled to their surplus and profits respectively based on this reference price. The present paper highlights four findings regarding what are the other psychological factors that can possibly alter the fairness norms of consumers. The findings are - First:Overriding the perfect self-interest hypothesis, consumers do exhibit other regarding preferences and show empathy towards loss making economic agents. They are also willing to incur costs to transact with such agents. Second: Consumer's decisions are guided by fairness norms but these norms can get modulated or relaxed depending on the urgency or the primacy of the need. Third: More loyal a consumer more will be her expectation of positive reciprocity from her supplier. This indicates that loyal consumers need to be handled by companies by care as they may have the propensity to punish their suppliers in case they are treated unfairly as per their fairness norms. Fourth: Failure of the consumer and labor markets to clear may be attributed to preference of people for stable prices and wages. People show aversion towards frequent changes in prices and wages.

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