

Is the price right? Fairness and Economics

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BUSINESS SCHOOL

The price of the 2011 Rugby World Cup All Black Jersey



- In 2011, just prior to the rugby world cup, Adidas New Zealand got into controversy for the price of the All Blacks jerseys
- Cost more than twice as much in New Zealand compared to their price overseas.
- What was it about?

Exploiting your market power: The story of fair trade coffee

- Consider Spicer's Coffee, a hypothetical coffee shop
- Ideally Spicer's wants to charge a high price (high mark-up) so as to get a higher profit
- But higher prices will drive some people away; the ones who are more price sensitive

Exploiting your market power: The story of fair trade coffee

- Charge everyone high price: greater profit margin per cup but fewer cups sold
- Charge low price: more cups sold but lower profit margin per cup
- Spicer's would really like to charge a higher price to those who are willing to pay more and charge less to those who are more price sensitive
- ***"Price discrimination!"***

Exploiting your market power: The story of fair trade coffee

➤ *Spicer's Menu:*

➤ *Flat white for the lavish: \$6.00*

➤ *Flat white for the thrifty: \$4.00*

➤ Will this work?

➤ ***No, because...arbitrage!***

Exploiting your market power: The story of fair trade coffee

- What if Spicer's offered a *"fair trade"* coffee and charged more?
- Producers of fair trade coffee do promise the farmers a higher price
- Thus it would cost Spicer's a bit more to buy the fair-trade coffee

Exploiting your market power: The story of fair trade coffee

- But a typical cup of flat white requires just about a quarter-ounce of coffee beans
- *The additional cost – typically a few cents - of using the more expensive fair trade coffee is much less than the premium charged to customers*
- The bulk of this premium charged to customers goes to the coffee seller's bottom-line!
- *But by ordering the fair trade coffee you send an important message to Spicer's*

Exploiting your market power: The story of fair trade coffee

- *"I really don't mind paying a bit more for my coffee"*
- **Spicer's Menu:**
 - *Flat white (with fair trade coffee beans) \$6.00*
 - *Translation: coffee for the bleeding heart liberal*
 - *Flat white (with regular coffee beans) \$4.00*
 - *Translation: coffee for the flinty-eyed spendthrift*

What does this have to do with the All Blacks jersey?

- According to Adidas New Zealand the price they set in New Zealand was “*relative to the local market*” .
- Essentially, Adidas New Zealand was engaging in nothing other than good old-fashioned **price discrimination**.
- Adidas New Zealand assumed that once the world cup got going – *and New Zealand started to win* – the fans would catch the fever and willingly snap up the high priced jerseys.

What does this have to do with the All Blacks jersey?

- This is why the person in the next seat on an airplane possibly paid a lot more than you did because s/he bought the ticket at the last minute while you bought yours two months back.
- When Kiwi supporters tried to order cheaper overseas jerseys on-line, Adidas moved aggressively to block such attempts at "**arbitrage.**"

What went wrong with Adidas' strategy?

- Public indignation rose so high that some local retailers started selling the jerseys at a loss; even the Prime Minister John Key weighed in on the debate.
- *However, the logic behind such pricing strategies depends on people's willingness to accept the price.*
- If enough people consider the price to be **unfair** and refuse to buy then profitable trades that should happen, no longer take place.

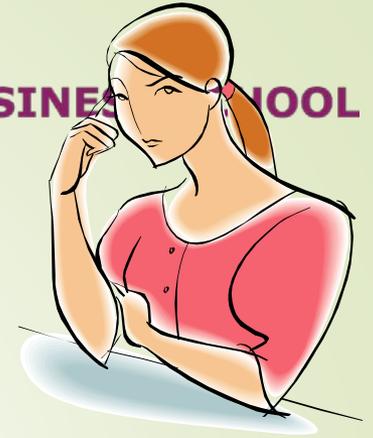
Fairness as a constraint on profit seeking

- Evidence suggests that such notions of fairness are fundamental to human interactions
- In my research, I use *economic decision games* to study such topics

Ultimatum Game



Proposer
Has \$10.00



Responder

Offer \$ X , $0 < X < 10$?
Keep \$ $(10 - X)$?

Accept?

If accept,
gets \$ $(10 - X)$

If accept, gets
\$ X

If reject, gets \$0.00

Reject?

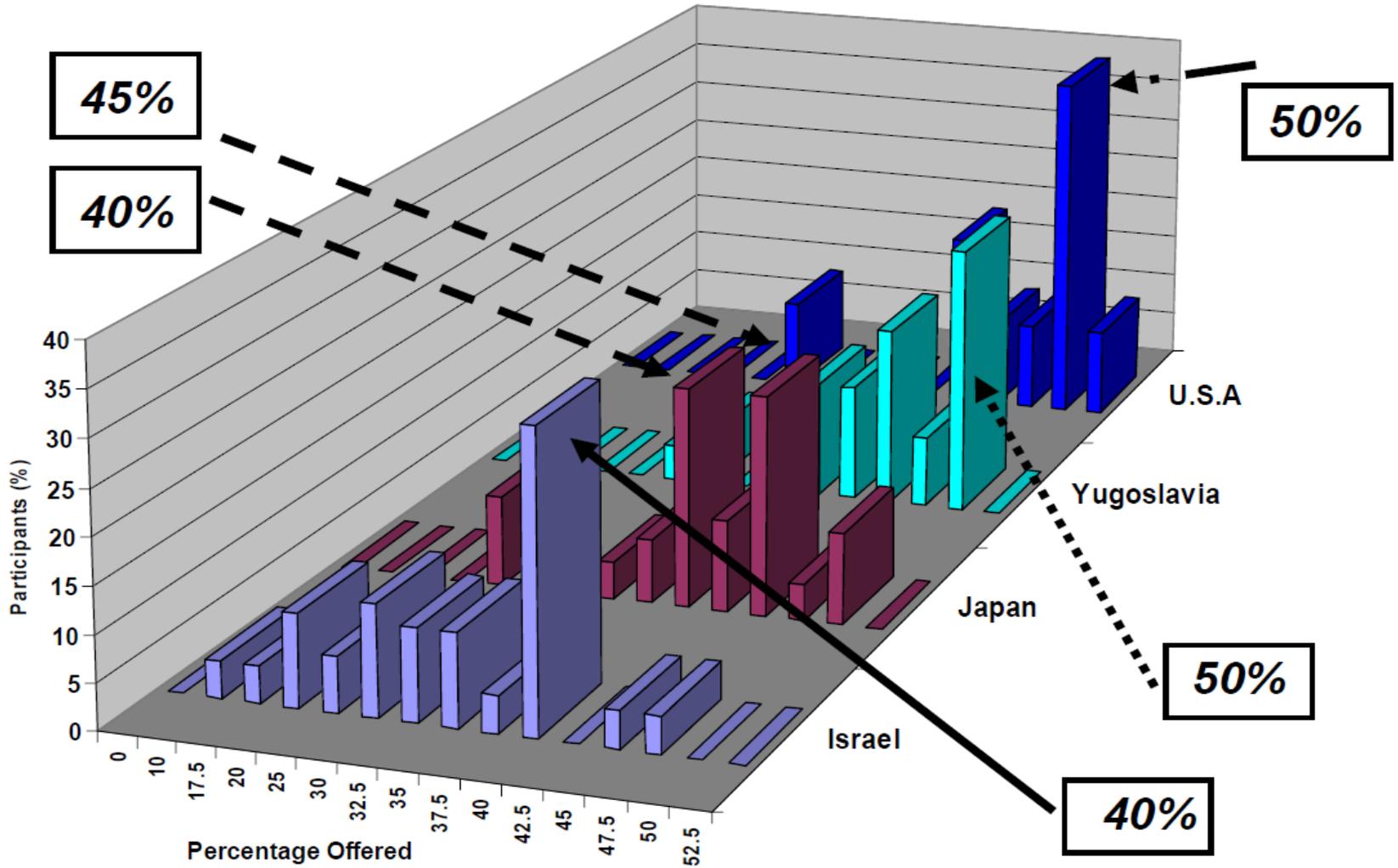
If reject, gets \$0.00

The Ultimatum Game

- Any amount, no matter how small, is better than zero...right?
- So the responder should accept any amount no matter how small...\$1, \$0.50...
- Anticipating that the proposer should offer a small amount and keep the rest...\$9.50, \$9.00...

The Ultimatum Game

- *But in reality proposers usually offer 40% - 50% of the pie to the responder*
- *Offers of 25% or less (\$2.50 out of \$10 OR \$25 out of \$100) routinely turned down by responders!*
- *“Fairness” of offers are a key consideration in accepting/rejecting offers*



Intentions matter!

- ▶ In rejecting “small” offers, are responders protesting the **“unfairness”** of offers or the **“inequity”** of the payoffs?
 - ▶ Say a split of \$9.00 for the proposer and \$1.00 for the responder
- ▶ *Compare offers made by humans with those generated at random by a computer*

Intentions matter!

- ▶ If responders only cared about their size of the pie, then they should reject “unfair” offers from both humans and computers
- ▶ But if responders care about intentional acts of unfairness then we would expect them to be
 - ▶ more willing to accept unfair offers made by chance
 - ▶ Less willing to accept unfair offers made by proposers

Intentions matter!

- The results demonstrated that it is the *unfairness* of offers, rather than relative payoffs, that people care about.
- *When offers made by human proposers, the minimum amount responders were willing to accept on average is \$2.91 (out of \$10).*
- *But when the offer is decided by chance the minimum acceptable amount is \$1.20.*

Fairness in real life: survey evidence

- Kahnemann, Knetsch and Thaler (1986)
- *A hardware store has been selling snow shovels for \$15. The morning after a large snowstorm, the store raises the price to \$20.*
- Respondents asked to rate this move as (1) completely fair; (2) acceptable; (3) unfair and (4) very unfair.
- *Out of 107 respondents to this question, 82% considered this unfair or very unfair.*

Fairness in real life: survey evidence

- *A landlord rents out a small house. When the lease is due for renewal, the landlord learns that the tenant has taken a job very close to the house and is therefore unlikely to move. The landlord raises the rent \$40 per month more than he was planning to do.*
- **Out of 157 respondents only 9% thought this was acceptable.**
- *Pricing strategies that deliberately exploit the dependence of a particular individual are unacceptable to many.*

Fairness in real life: survey evidence

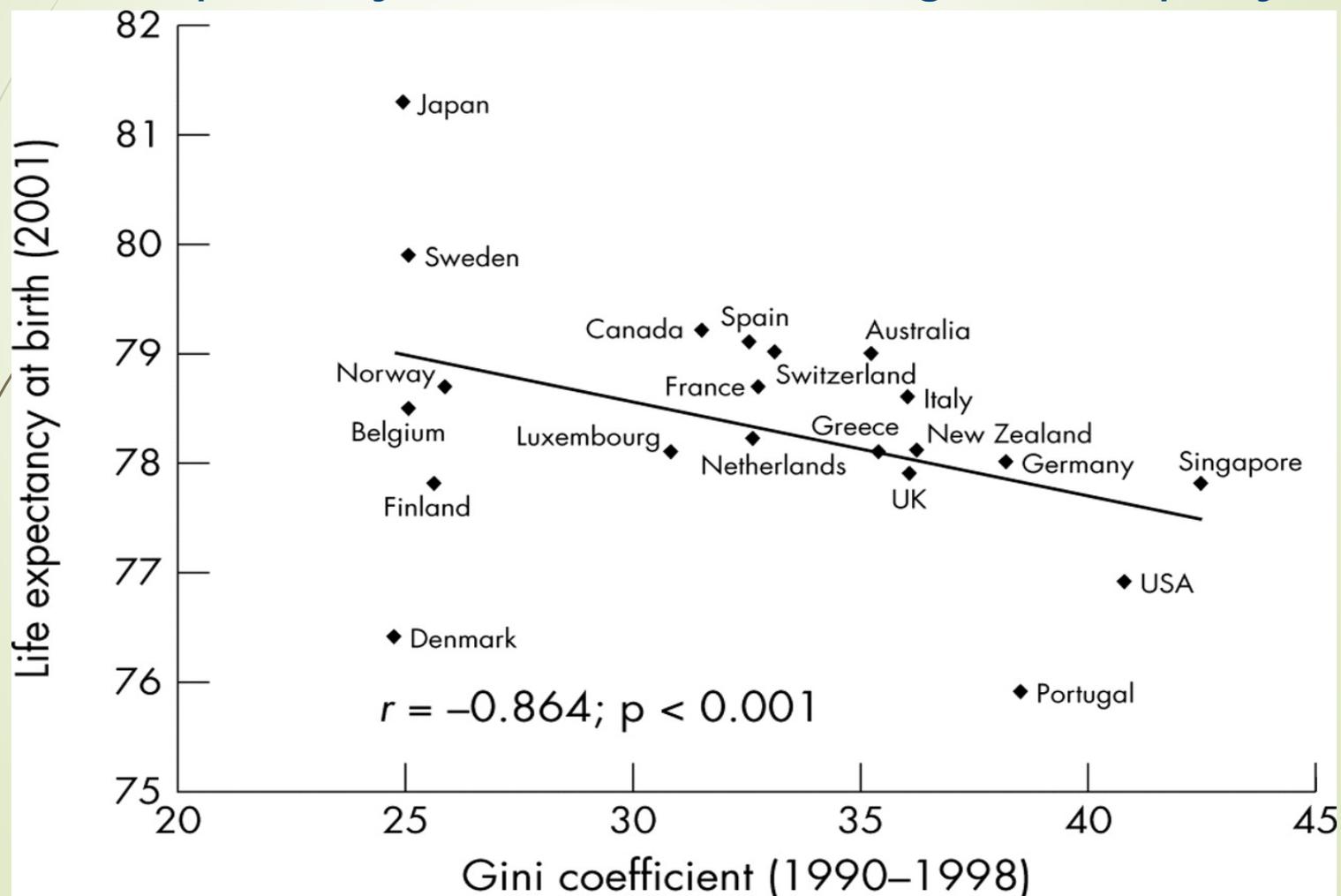
- *A small company employs several workers and has been paying them average wages. There is severe unemployment in the area and the company could easily replace its current employees with good workers at a lower wage. The company has been making money. The owners reduce the current workers' wages by 5 percent.*
- **77% of 195 respondents found this unacceptable.**

Inequity aversion among Capuchin monkeys

- ▶ <https://www.youtube.com/watch?v=meiU6TxysCg&t=5s>
- ▶ <https://www.youtube.com/watch?v=meiU6TxysCg&t=100s>
- ▶ <https://www.youtube.com/watch?v=-KSryJXDpZo>

Inequality and its impact: At the Macro Level

Life expectancy is lower in countries with greater inequality



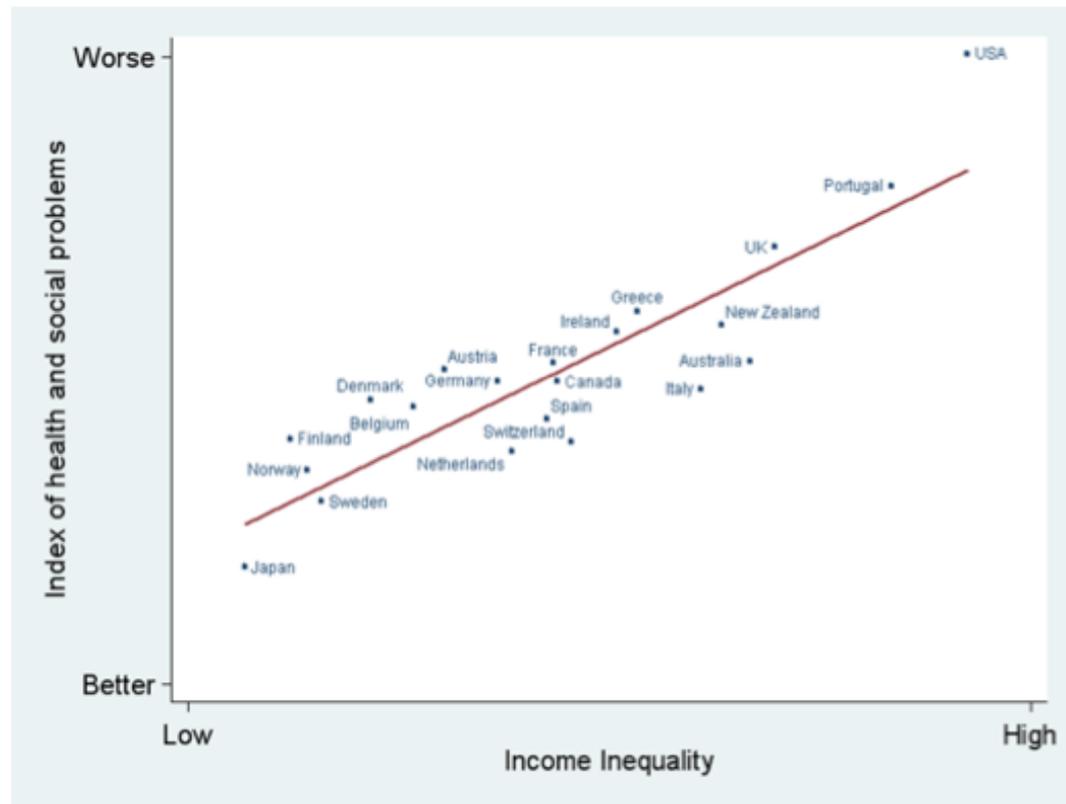


Inequality and its impact: At the Macro Level

Health and Social Problems are Worse in More Unequal Countries

Index of:

- Life expectancy
- Math & Literacy
- Infant mortality
- Homicides
- Imprisonment
- Teenage births
- Trust
- Obesity
- Mental illness – incl. drug & alcohol addiction
- Social mobility





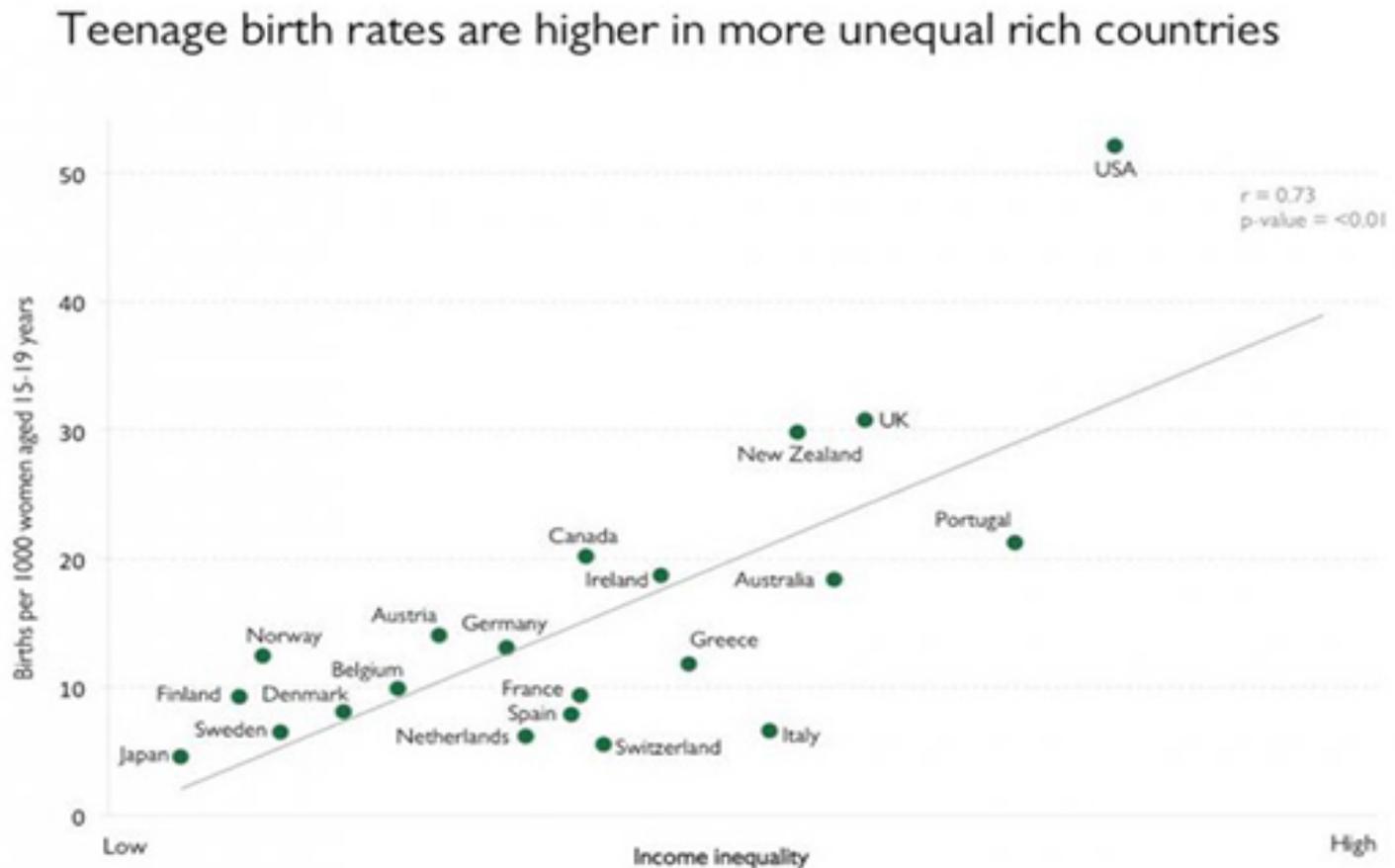
Inequality and its impact: At the Macro Level

Infant Mortality Rates are Higher in More Unequal Countries





Inequality and its impact: At the Macro Level



But is it about inequality or fairness?

nature
human behaviour

PERSPECTIVE

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Why people prefer unequal societies

Christina Starmans*, Mark Sheskin and Paul Bloom

There is immense concern about economic inequality, both among the scholarly community and in the general public, and many insist that equality is an important social goal. However, when people are asked about the ideal distribution of wealth in their country, they actually prefer unequal societies. We suggest that these two phenomena can be reconciled by noticing that, despite appearances to the contrary, there is no evidence that people are bothered by economic inequality itself. Rather, they are bothered by something that is often confounded with inequality: economic unfairness. Drawing upon laboratory studies, cross-cultural research, and experiments with babies and young children, we argue that humans naturally favour fair distributions, not equal ones, and that when fairness and equality clash, people prefer fair inequality over unfair equality. Both psychological research and decisions by policymakers would benefit from more clearly distinguishing inequality from unfairness.

Is it inequality or (un)fairness?

- There is immense concern about economic inequality
- However, when people are asked about the ideal distribution of wealth...*they don't necessarily prefer equal societies.*
- These two phenomena can be reconciled by noticing that, ... (people) are bothered by something that is often confounded with inequality: *economic unfairness.*

Preference for (in)equality?



Figure 2 | The actual US wealth distribution plotted against the estimated and ideal distributions across all respondents. Because of their small percentage share of total wealth, both the fourth 20% value (0.2%) and the bottom 20% value (0.1%) are not visible in the actual distribution. Figure adapted with permission from ref. 11, SAGE.

Is it inequality or (un)fairness?

- E.g., 6-8 year old children had to award erasers to two boys who had cleaned up their room.
- If an unequal number of erasers available, children preferred to throw away an extra eraser than create an unequal distribution.
- But when told that one boy did more work than the other, they awarded the extra eraser to the hard worker.

Is it inequality or (un)fairness?

- In fact, when one recipient has done more work, six-year-olds believe that he or she should receive more resources, even if equal pay is an option.
- Likewise, although infants prefer equality in a neutral circumstance, they expect an experimenter to distribute rewards preferentially to individuals who have done more work.

Is it inequality or (un)fairness?

- Consider a situation with two individuals, identical in all relevant regards, where one gets 10 dollars and the other gets nothing. This is plainly unequal, but is it fair?
- It can be, if the allocation was *random*.
- Adults consider it fair to use *impartial procedures* such as coin flips and lotteries when distributing resources.

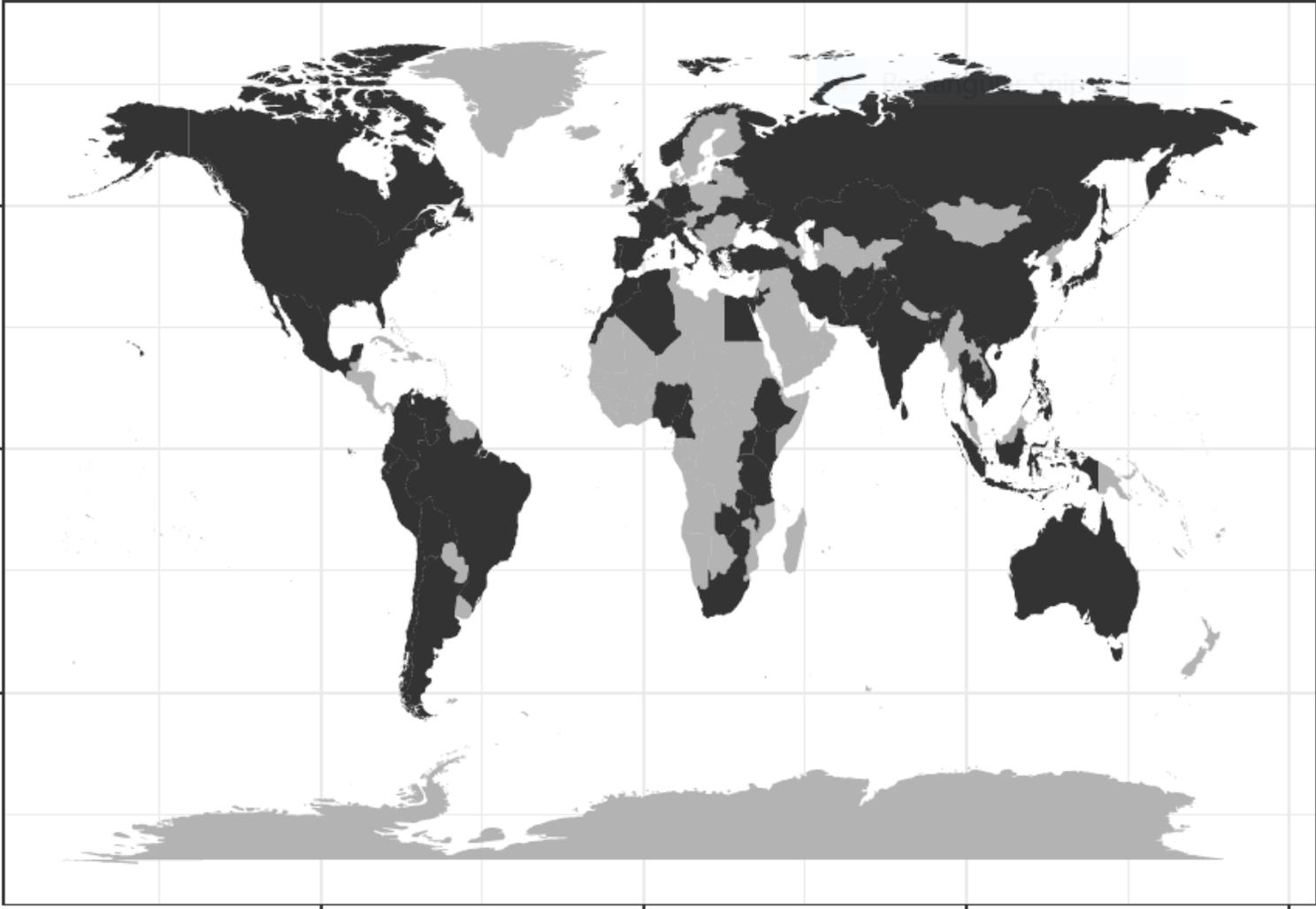
Is it inequality or (un)fairness?

- ▶ Children (even as small as 3-year olds) have similar views.
- ▶ In the erasers-for-room-cleaning studies described above, if children are given a fair 'spinner' to randomly choose who gets the extra eraser, they are happy to create inequality.

Fairness Across the World: Preferences and Beliefs

Ingvild Almås^{1,2} Alexander W. Cappelen¹
Erik Ø. Sørensen¹ Bertil Tungodden¹

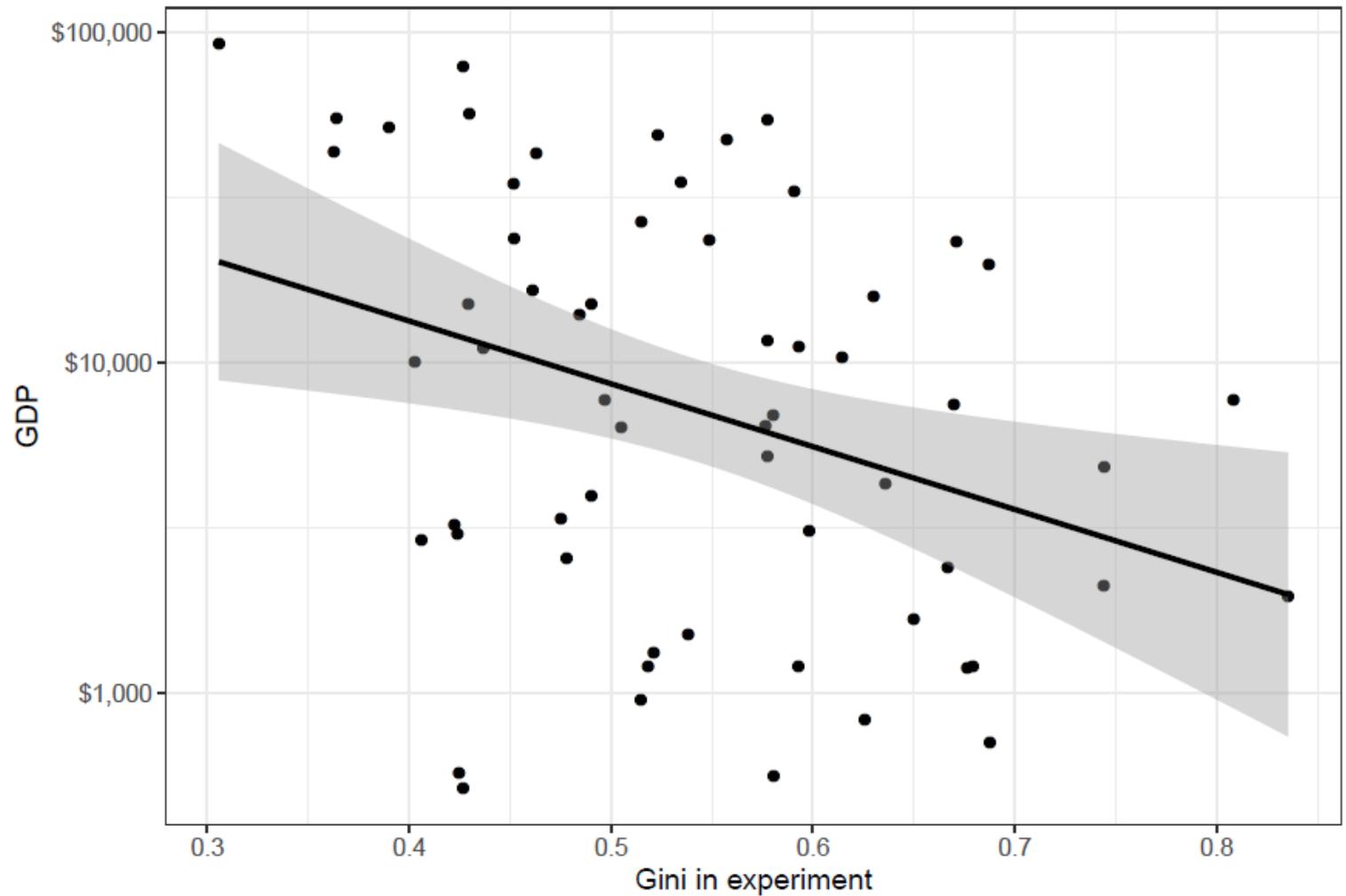
Countries included in the study



List of countries

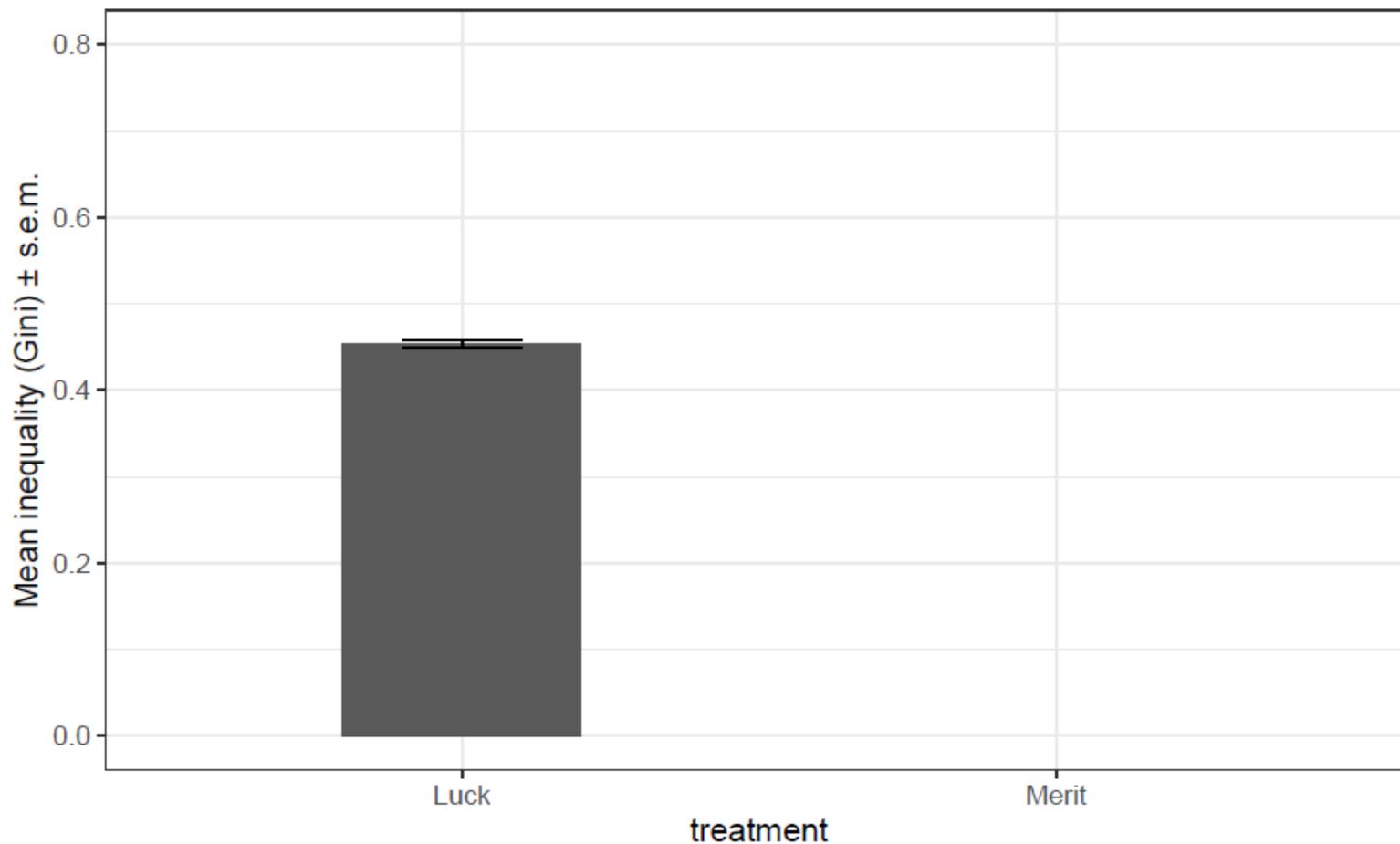
- ▶ The 60 countries are: Afghanistan, Algeria, Argentina, **Australia**, Bangladesh, Bolivia, Brazil, Cambodia, Cameroon, Canada, Chile, China, Colombia, Croatia, Czech Republic, Ecuador, Egypt, Estonia, Ethiopia, France, Germany, Greece, Hungary, India, Indonesia, Iran, Israel, Italy, Japan, Jordan, Kazakhstan, Kenya, Malawi, Mexico, Morocco, Netherlands, Nigeria, Norway, Pakistan, Peru, Philippines, Portugal, Russia, Rwanda, South Africa, South Korea, Spain, Sri Lanka, Switzerland, Tanzania, Thailand, Turkey, Uganda, Ukraine, United Kingdom, USA, Venezuela, Vietnam, Zambia, and Zimbabwe.
- ▶ Covers all the large economies and 80% of the world population.

Is there less inequality acceptance in rich countries?

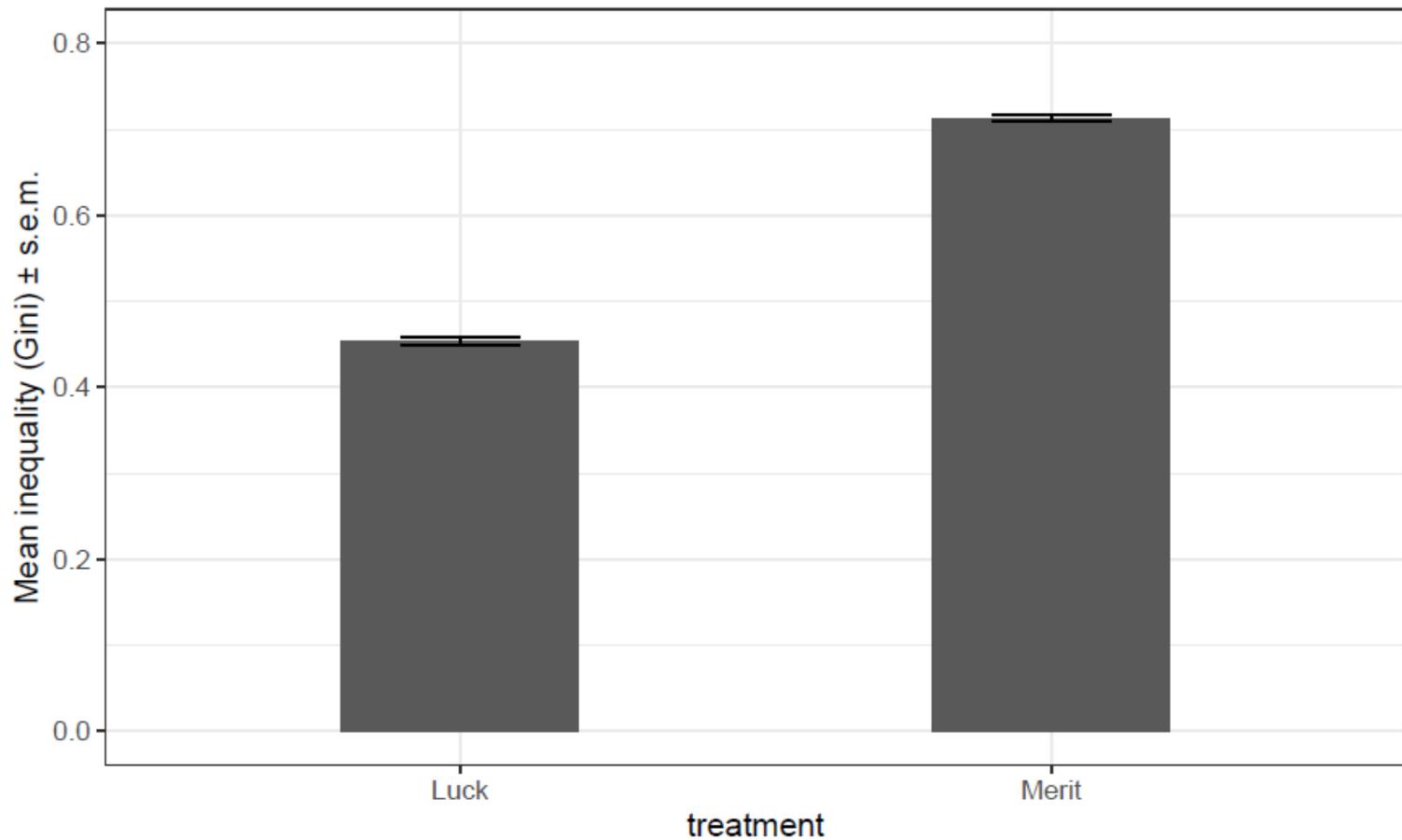


Gini in the experiment includes the luck and the merit treatment

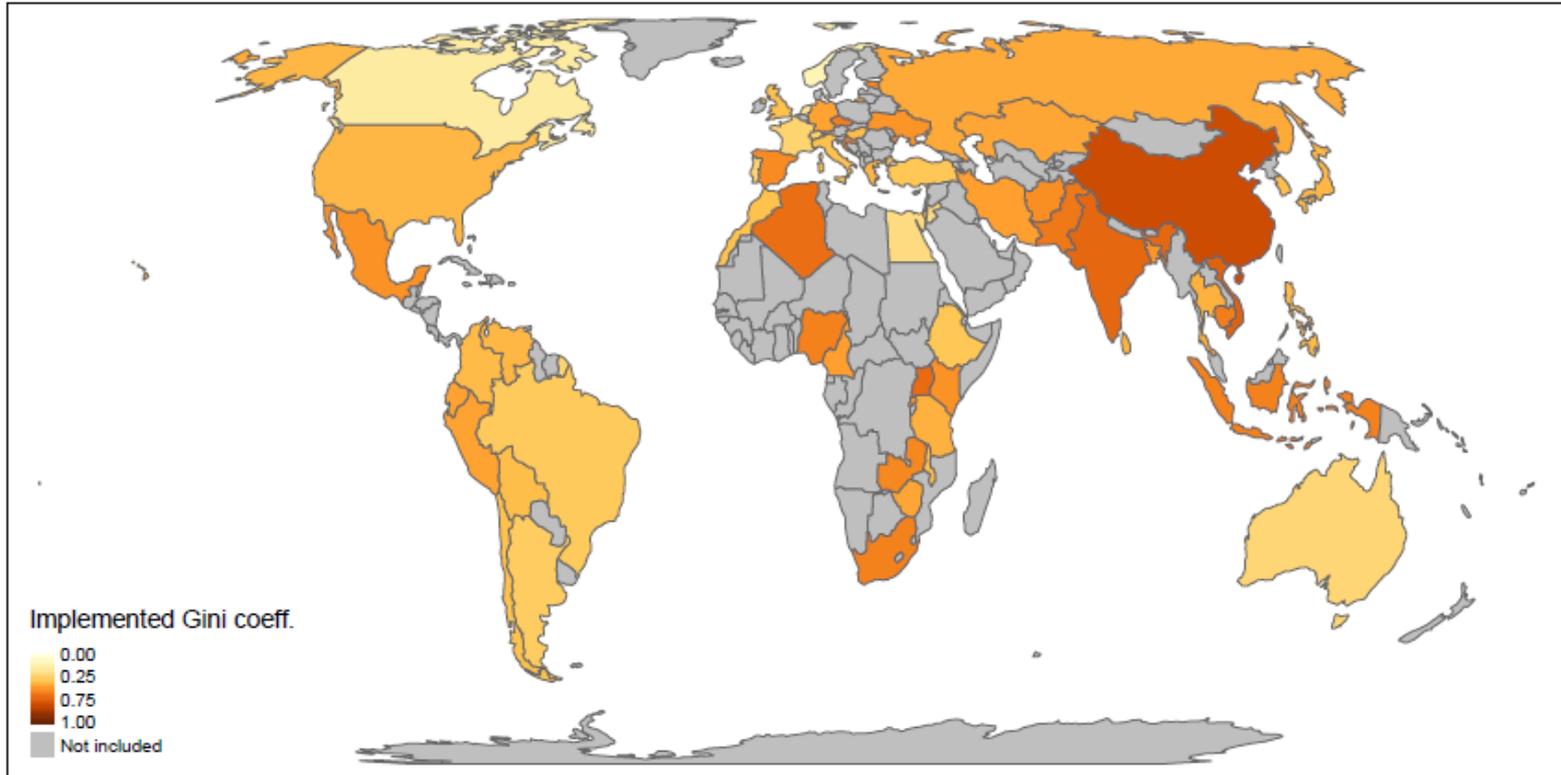
Implemented inequality in Luck and Merit treatments



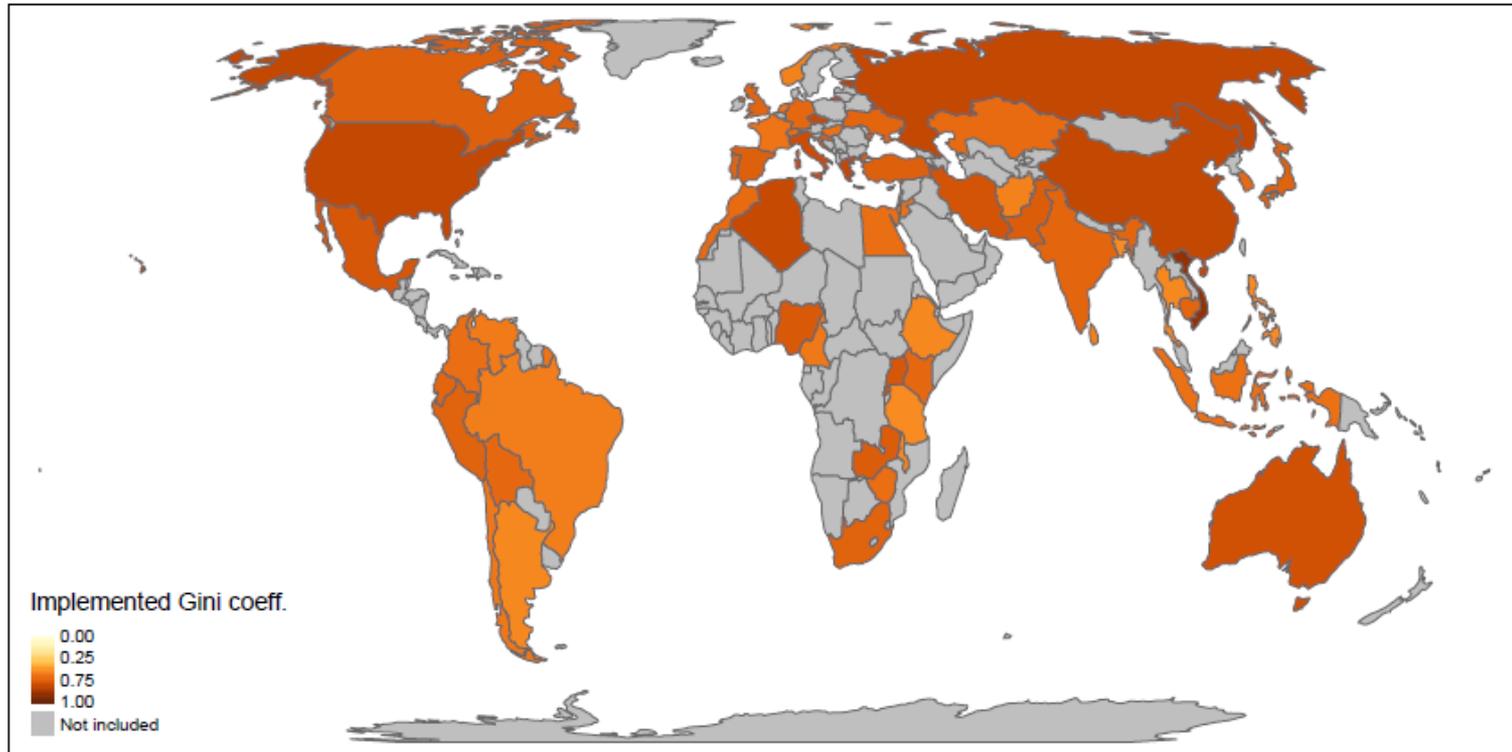
Implemented inequality in Luck and Merit treatments



Luck: Implemented Gini



Merit: Implemented Gini



Concluding thoughts

- Notions of fairness fundamental to human judgements
- Can lead to market outcomes not predicted by traditional economic theories
- At times, it appears that objections to inequality, are in reality grounded in objections to lack of fairness of outcomes, than unequal outcomes *per se*.
- Obvious implications for policy; particularly with regards to tax policy, education, and ensuring social mobility

Questions?



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