Hotel News Resource

In the Game of Business, Playing Fair Can Actually Lead to Greater Profits

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Tune into 'The Apprentice,' and you get an all-too-common view of business. Every week, all of the wannabe moguls try to impress Donald Trump by preening, cajoling and conniving. In this world, toughness is the measure of every CEO, and the boss glories in firing people and squeezing every penny out of suppliers.

Yet according to John Zhang and Jagmohan Raju, both Wharton marketing professors, and Tony Haitao Cui, a University of Minnesota marketing and logistics professor, many people aren't purely mercenary in their business dealings. They care about fairness -- and they should, the researchers say, because doing so can maximize their profits.

A manufacturer and a retailer can both end up making more money if they are fair minded, setting prices with an eye to achieving an equitable outcome in their joint marketing channel as opposed to merely maximizing their individual profits, Zhang, Raju and Cui argue in a paper recently published in Management Science titled, "Fairness and Channel Coordination."

When people are fair minded, they don't need to waste time on elaborate negotiations or enter into complicated contracts to coordinate their marketing channel and maximize profitability, the authors contend in their paper. "A constant wholesale price will do. When a fair channel is coordinated through a constant wholesale price, the retailer perceives no inequity. Therefore, a constant wholesale price as a channel-coordination mechanism can help to foster an equitable channel relationship."

Call it a new glove for the Invisible Hand: The manufacturer sets his price, and the retailer's sense of fairness takes care of the rest. "We show that you don't need elaborate coordination contracts because concern about fairness creates coordination, which perhaps explains the prevalence of using simple wholesale prices as channel contracts," Zhang says.

Here's how it works. When the retailer sees that he is being treated fairly by the manufacturer, he will reciprocate by picking a retail price that rewards the manufacturer. Because each gets an equitable share of the channel's profit, they won't squabble. "If you are fighting against each other, ultimately the whole channel will suffer," Zhang notes.

Conventional wisdom says that the manufacturer needs to enter into an elaborate contract with the retailer to align their interests. It may take the form of revenue sharing, quantity discounts or two-part tariffs. "In practice, you rarely see that," Zhang points out. "You mostly see a simple wholesale price contract. Given that, what's happening? What we show is that, as a retailer, you care about fairness: You want to be treated nicely, and you'll treat me nicely if I treat you that way."

For this kind of coordination to work, the retailer has to be able to ascertain the manufacturer's costs. Otherwise, he can't guage fairness of the wholesale price. "With transparency, it works better," Zhang says. "You would know what's fair and what's not." Without it, you have to rely simply on reputation and trust, which can take a long time to develop."

Transparency isn't a difficult condition to satisfy. Retailers typically have access to information on their suppliers' costs. This is true, for instance, "when the manufacturer supplies a standardized product or a commodity," the three scholars write. "In that case, competitive offers from manufacturers will reveal [significant cost information] to a retailer. This is also the case when the retailer engages in the private-label business and therefore knows quite a bit about manufacturers' cost structure."

Fairness over Profit Maximization

Zhang, Raju and Cui's model is rooted in the emerging field of behavioral economics. Behavioralists, as practitioners are known, have shown with experiments that people sometimes value fairness over profit maximization. In one such experiment, called the ultimatum game, one player receives a sum of money and gets to propose how to split it with a second player. The second player must accept the proposed division for either of them to receive any of the cash, if she rejects it, both end up with nothing. Classical economic theory suggests that the proposer should keep just about everything for himself -- say, 99% -- and offer just a crumb to the person across the table. That way, he has maximized his benefit, and the other player will accept because she's a bit better off than she was. In reality, responders typically reject splits in which they receive less than 20%. In some cultures, people will even reject splits of less than 50/50.

"The ultimatum game tells you that people aren't hard-nosed economists," Zhang says. "They are fair minded. And this kind of experimental outcome has strategic implications. We are saying that you don't need a hard-nosed attitude to make a profit in the real world. In some areas, fairness will address the channel relationship in such a way that everyone can be better off."

A model is necessarily a perfect microcosm. The three scholars' theory assumes that the retailer cares about fairness and shows how, if he does, that this can lead to better outcomes for both. But Zhang believes that it's a reasonable approximation of how people really conduct themselves. "This is behavior that we're indoctrinated in," he says. "It's hardwired in our head. If we behave unfairly, we feel bad about ourselves." It's why people don't typically propose 99/1 splits in the ultimatum game and why they reject divisions perceived as unfair.

Skunks and Chimps

Findings in the emerging field of neuroeconomics, which combines economics and neuroscience, reinforce these ideas, the scholars point out in their paper. Researchers have done magnetic resonance imaging (MRI) scans on people’s brains while they are receiving offers like the ones in the ultimatum game. When subjects feel they have been cheated, a part of the brain called the anterior insula lights up --the same area that responds when they smell something disgusting, like a skunk.

Interestingly, chimpanzees recently have been shown not to be burdened by the same sort of economic scruples. A study conducted by scientists at the Max Planck Institute of Evolutionary Anthropology in Germany found that chimps had no concern for fairness. Working with trays and raisins, they would accept any division as long as they received at least one raisin, rejecting only offers where they got nothing. They were, in other words, more economically rational, at least in the classical sense, than humans.

Zhang acknowledges that, in the real world, people’s conduct can resemble that of chimps. "You do have to watch out for opportunistic behaviors." Sometimes, social norms will prevent these people from trying to take advantage of those with whom they do business. They might be concerned about their reputation. Or if they have repeated interactions with someone else, they might act fairly out of fear of reprisal.

"When you don’t have repeated interactions, that’s when you have to worry," Zhang says. "It’s like a tourist who doesn’t leave a tip on the table because he thinks he’ll never come back to the restaurant."

Large companies, because of their impersonality, might create situations where people care less about treating others fairly. That can be especially true if their employees are compensated for achieving short-term goals. "All else being equal, if you are working for a bigger company and you will get promoted if you make a short-term profit, you don’t worry so much about fairness," Zhang says. "However, disregarding fairness can be detrimental to the company in the long run, as fairness is the lubricant for the sales machinery."

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