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Ethical differentiation and market behavior: An experimental approach

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Abstract

Does ethical differentiation of products affect market behavior? We examined this issue in triopolistic experimental markets where producers set prices. One producer's costs were higher than the others. In two treatments, the additional costs were attributed to compliance with ethical guidelines. In the third, no justification was provided. Many consumers reduced their experimental gains by purchasing the ethically differentiated products at higher prices. Individual differences were important (business/economics students paid smaller premia). Finally, we speculate about the observed "demand function" for ethics and emphasize using experimental methodology to complement empirical studies in assessing markets for ethically differentiated products.

JEL classification: A13; B41; D43; D46

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In recent years, an increasing number of firms have started to signal that their products are produced under "fair" conditions (e.g., no child labor or no exploitation of agricultural workers). In 2002, for example, the total market for such "ethical consumption" was estimated at £19.9 billion in the UK alone (Cooperative Bank, 2003). In the EU and the USA, fair trade organizations reported increases in sales of labeled products for 2003 over 2002 that varied between 42 percent

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and 91 percent. Moreover, similar growth rates have been observed for several years (for data see FLO, 2006; TransfairUSA, 2004).

Prices of fair trade products are typically higher than those of the substantially equivalent products with which they compete in the marketplace, yet there is little empirical evidence about the conditions under which consumers are prepared to pay higher prices (i.e., "ethical premia"). In discussing the role of ethics in the market place, Shleifer (2004, p. 417) uses the example of child labor, stating that "if public opinion really turns against child labor, firms that do not hire children will be able to charge higher prices." Knowing when and to what degree such shifts in preferences occur is clearly an important practical issue.

Several surveys have already estimated consumers' willingness-to-pay for ethical products[1] (see, e.g., De Pelsmacker et al., 2003). These data are hypothetical and represent attitudes that may or may not result in purchases. Thus, it is legitimate to question whether they generalize to market behavior (Carrigan and Attalla, 2001; Tallontire et al., 2001). In addition, although econometric studies using market data are more credible (cf., Bjorner et al., 2004), they are subject to market frictions (e.g., limited distribution to special stores, lack of consumer information), and the variability that consumers face in observed ethical premia is limited.

Recently, some researchers have used field experiments as a methodology to overcome these problems. Anderson and Hanson (2004) report an experiment conducted at two Home Depot stores in Oregon, where "ecolabeled" and unlabeled plywood products were sold side by side. They found that the labeled version of the product accounted for 37 percent of all sales when priced at a premium of 2 percent. Kimeldorf et al. (2006) use a "good working conditions" label to differentiate otherwise equivalent sport socks in a department store in Michigan. They show that, even at a price premium of 40 percent, nearly a quarter of sales are from the labeled version of the product. They further show that the share of "ethical" sales is sensitive to changes in the size of the premium. While field experiments have the advantage of unambiguously testing "true" purchasing actions in the presence of a labeled product, they also face serious difficulties. For instance, as the authors of both studies point out, consumer information about the label is difficult to assure in a field setting.[2] In addition, field studies cannot control for sample selection since customers may seek or avoid the choice between labeled and non-labeled versions of a product.

The purpose of this paper is to apply the methodology of experimental economics to assess how much consumers are prepared to pay for "ethically produced" goods and thereby complement evidence from field studies. The principal advantages are that trade-offs between ethical values and monetary incentives are measured by consumers' choices in controlled settings and that all participants have to make these decisions under conditions of sufficient and equal information. More specifically, we constructed a triopolistic experimental market environment with fixed demand and posted-offer pricing, where three producers and six consumers interacted in a finitely repeated trading sequence. We chose oligopolistic price competition for its simplicity and close resemblance to commonly observed retail markets. Experimental studies of such price competition confirm theoretical Bertrand predictions for three or more producers (Fouraker and Siegel, 1963; Dufwenberg and Gneezy, 2000). With this design, we sought to observe producers' pricing behavior and consumers' purchases when an ethical dimension is at play. We introduced an asymmetry in production costs, as done by Gneezy and Nagel (2001) for a comparison of symmetric and

[1] We use the term "ethical" in a broad sense to cover considerations of so-called "fair trade" and more specific issues such as labor standards, discrimination, and the like.

[2] Interviews in the sport socks study revealed that more than half of all consumers either did not notice or did not understand the label.