

DISCUSSION PAPER SERIES

No. 5368

THE ROLE OF EQUALITY AND EFFICIENCY IN SOCIAL PREFERENCES

Ernst Fehr, Michael Naef and Klaus M.
Schmidt

INDUSTRIAL ORGANIZATION



Centre for **E**conomic **P**olicy **R**esearch

www.cepr.org

Available online at:

www.cepr.org/pubs/dps/DP5368.asp

THE ROLE OF EQUALITY AND EFFICIENCY IN SOCIAL PREFERENCES

Ernst Fehr, University of Zurich and CEPR
Michael Naef, University of Zurich
Klaus M. Schmidt, University of Munich and CEPR

Discussion Paper No. 5368
December 2005

Centre for Economic Policy Research
90–98 Goswell Rd, London EC1V 7RR, UK
Tel: (44 20) 7878 2900, Fax: (44 20) 7878 2999
Email: cepr@cepr.org, Website: www.cepr.org

This Discussion Paper is issued under the auspices of the Centre's research programme in **INDUSTRIAL ORGANIZATION**. Any opinions expressed here are those of the author(s) and not those of the Centre for Economic Policy Research. Research disseminated by CEPR may include views on policy, but the Centre itself takes no institutional policy positions.

The Centre for Economic Policy Research was established in 1983 as a private educational charity, to promote independent analysis and public discussion of open economies and the relations among them. It is pluralist and non-partisan, bringing economic research to bear on the analysis of medium- and long-run policy questions. Institutional (core) finance for the Centre has been provided through major grants from the Economic and Social Research Council, under which an ESRC Resource Centre operates within CEPR; the Esmée Fairbairn Charitable Trust; and the Bank of England. These organizations do not give prior review to the Centre's publications, nor do they necessarily endorse the views expressed therein.

These Discussion Papers often represent preliminary or incomplete work, circulated to encourage discussion and comment. Citation and use of such a paper should take account of its provisional character.

Copyright: Ernst Fehr, Michael Naef and Klaus M. Schmidt

CEPR Discussion Paper No. 5368

December 2005

ABSTRACT

The Role of Equality and Efficiency in Social Preferences*

Engelmann and Strobel (AER 2004) question the relevance of inequity aversion in simple dictator game experiments claiming that a combination of a preference for efficiency and a Rawlsian motive for helping the least well-off is more important than inequity aversion. We show that these results are partly based on a strong subject pool effect. The participants of the E&S experiments were undergraduate students of economics and business administration who self-selected into their field of study (economics) and learned in the first semester that efficiency is desirable. We show that for non-economists the preference for efficiency is much less pronounced. We also find a non-negligible gender effect indicating that women are more egalitarian than men. However, perhaps surprisingly, the dominance of equality over efficiency is unrelated to political attitudes.

JEL Classification: C7, C91, C92, D63 and D64

Keywords: inequity aversion, preferences for efficiency and social preferences

Ernst Fehr
Institute for Empirical Research in
Economics
University of Zurich
Bluemlisalpstrasse 10
CH-8006 Zurich
SWITZERLAND

Tel: (41 1) 634 37 09
Fax: (41 1) 634 49 07
Email: efehr@iew.unizh.ch

For further Discussion Papers by this author see:
www.cepr.org/pubs/new-dps/dplist.asp?authorid=135748

Michael Naef
Institute for Empirical Research in
Economics
University of Zurich
Bluemlisalpstrasse 10
CH-8006 Zurich
SWITZERLAND

Email: aef@iew.unizh.ch

For further Discussion Papers by this author see:
www.cepr.org/pubs/new-dps/dplist.asp?authorid=163678

Klaus M. Schmidt
Department of Economics
University of Munich
Ludwigstrasse 28
D-80539 München
GERMANY

Tel: (49 89) 2180 2250
Fax:(49 89) 2180 3510
Email: klaus.schmidt@Lrz.uni-
muenchen.de

For further Discussion Papers by this author see:
www.cepr.org/pubs/new-dps/dplist.asp?authorid=118063

*Corresponding Author: Fehr. A previous version of this paper was circulated under the title: 'The Role of Equality, Efficiency and Rawlsian Motives in Social Preferences'. We would like to thank Susanne Kremhelmer for excellent research assistance and Mathias Erlei for very helpful comments on an earlier version of this paper. Part of this research was conducted while the third author visited Yale University; he would like to thank the Economics Department for its great hospitality. Financial support by Deutsche Forschungsgemeinschaft through SFB-TR 15 and by the EU-Marie Curie RTN ENABLE (MRTM-CT-2003-505223) is gratefully acknowledged. Ernst Fehr also gratefully acknowledges support from the Swiss National Science Foundation (project number 101312 – 103898/1), the Network on the Evolution of Preferences and Social Norms of the MacArthur Foundation and the EU-Research Network ENABLE (MRTM-CT-2003-505223).

Submitted 11 November 2005

A major puzzle in the literature on social preferences is that a large majority of subjects behaves as if completely self-interested in some circumstances, such as in competitive experimental markets with standardized goods or in the final rounds of public goods experiments, while in other circumstances a large majority behaves as if strongly motivated by fairness concerns, e.g., in competitive markets with incomplete contracts or in public goods experiments with punishment opportunities. Recently developed models of inequity aversion (Bolton and Ockenfels 2000, Fehr and Schmidt 1999) can explain this puzzle by assuming a heterogeneous population of selfish and inequity averse subjects. Engelmann and Strobel (2004, henceforth E&S) question the relevance of inequity aversion in simple dictator game experiments, claiming that a combination of a preference for efficiency¹ and a Rawlsian motive for helping the least well-off is more important than inequity aversion.

In this paper, we show that E&S overstate the relevance of efficiency motives and understate the relevance of inequity aversion. The participants of the E&S experiments were undergraduate students of economics and business administration. These subjects self-selected into their field of study (economics) and learned in the first semester that efficiency is desirable. Non-economists, however, may value efficiency much less than economists do. We replicated the most relevant E&S experiments with various subject pools and are able to show that the dominance of the efficiency motive over the equity motive is restricted to students of economics and business administration. Students from various other disciplines and a sample of non-academic employees value equality much more highly than efficiency.

This raises the question whether there are other subject characteristics such as gender or the political attitudes that affect the preferences for efficiency versus equality. We find a non-negligible gender effect indicating that women are more egalitarian than men. However, perhaps surprisingly, the dominance of equality over efficiency is unrelated to political attitudes, i.e., subjects who vote for right wing parties and favor right wing political attitudes are as likely to favor equality as are subjects with left wing attitudes.

I. Economists versus Non-Economists

The most interesting results of E&S concern their treatments Ey and P that are designed to discriminate between preferences for efficiency, the Rawlsian maximin motive, and

¹ “Efficiency” in Engelmann and Strobel (2004) is not defined as Pareto-efficiency but as surplus maximization.

inequity aversion (see Table 1 below). In both treatments, Person 2 is the decision maker (dictator) who can choose between allocations A, B, and C. Note that own choices never affect Person 2's payoff. Person 2 can redistribute income from a richer Person 1 to a poorer Person 3 in both treatments by choosing allocations B or C instead of allocation A. However, choices B and C involve a relatively high efficiency loss. In treatment Ey, every additional money unit that is given to the poor person reduces the rich person's income by 4 money units, while the rich person suffers an income reduction of 3 units if the poor person's income is increased by one unit in treatment P. In both treatments a choice of the efficient allocation A not only constitutes evidence against specific functional form assumptions (like piece-wise linearity or positional asymmetry, meaning that subjects prefer advantageous inequity to disadvantageous inequity) in the Fehr-Schmidt approach, but also against general non-linear versions of inequity aversion.² Treatment P is particularly important because the decision maker (Person 2) always earns the lowest income independent of which allocation is implemented. Thus, the decision cannot be affected by Rawlsian preferences. Therefore, treatment P constitutes a clean test of the relevance of inequity aversion in comparison to the efficiency motive.

The E&S evidence for treatment P also illustrates an important point regarding the interpretation of their results. E&S conclude that “inequality aversion does not seem to be a major part in a complete explanation” of their data. This conclusion is based on their logit regressions which neglect any individual heterogeneity.³ However, 1/3 of their subjects choose the most inefficient and most egalitarian allocation in treatment P suggesting that they are motivated by inequality aversion (see Table 1). Perhaps the most important message that comes from social preferences models is that in strategic interactions the heterogeneity of social preferences is extremely important. As shown in Fehr and Schmidt (1999) even a minority of inequality averse subjects may have powerful effects on the outcome of strategic interactions. Thus, even if it were true that in general

² The inequity aversion approach by Fehr and Schmidt is compatible with the evidence in several other games conducted by E&S (the “envy” games) if one allows for non-linear forms of inequity aversion and gives up the assumption of positional asymmetry.

³ The conditional logit analysis in E&S is problematic for two reasons. First, E&S can only estimate the preferences of an “average subject” which neglects any individual heterogeneity. Second, the independent variables *Eff* (which captures the sum of the subjects payoff), *Self* (which captures the decision maker's own payoff), *FS α* (which captures the disadvantageous inequality) and *FS β* (which captures advantageous inequality) are linearly dependent. Thus, they have to exclude one or more of these variables from the analysis. The decision which variable one should exclude is, however, completely arbitrary but has strong effects on the regression outcomes. If, as E&S do, *Self* is excluded, *FS α* and *FS β* are not significant. If, however, *FS β* is excluded, *Self* and *Eff* are not significant. Thus, if one takes their regression approach seriously, one could equally well conclude that concerns for efficiency are irrelevant. To make things worse, if one arbitrarily excludes *Eff* from the analysis *Self* and *FS α* suddenly become highly significant. We owe this argument to Mathias Erlei who respecified and reestimated the E&S regressions.

only 1/3 of the population is motivated by inequality aversion, this motive can have important effects. However, as we will see below, among noneconomists much more than 1/3 of the subjects seem to be motivated by inequality aversion.

TABLE 1 – SUBJECT POOL EFFECTS: ECONOMISTS VERSUS NON-ECONOMISTS

Allocation	Treatment Ey			Treatment P		
	A	B	C	A	B	C
Person 1 Payoff	21	17	13	14	11	8
Person 2 Payoff	9	9	9	4	4	4
Person 3 Payoff	3	4	5	5	6	7
Total Payoff	33	30	27	23	21	19
Average Payoff of 1 and 3	12	10.5	9	9.5	8.5	7.5
Efficiency prediction	A			A		
Inequity aversion prediction (BO & FS)				C		
Rawlsian maximin prediction	C			A	or B	or C
Engelmann & Strobel results						
Economists: Humboldt Univ. Berlin						
(A) Choices (absolut)	12	7	11	18	2	10
Choices (percent)	40	23.3	36.7	60	6.7	33.3
Economists: University of Munich						
(B) Choices (absolut)	72	12	25	63	16	30
Choices (percent)	66.1	11	22.9	57.8	14.7	27.5
Non-Economists: University of Munich						
(C) Choices (absolut)	22	13	48	21	17	45
Choices (percent)	26.5	15.7	57.8	25.3	20.5	54.2
Non-Economists: Zurich, Switzerland						
(D) Choices (absolut)				8	8	20
Choices (percent)				22.2	22.2	55.6
Economists: Zurich, Switzerland						
(E) Choices (absolut)	31	9	18	31	9	18
Choices (percent)	53.5	15.5	31	53.5	15.5	31
Non-Economists: Zurich, Switzerland						
(F) Choices (absolut)	61	23	78	53	25	84
Choices (percent)	37.7	14.2	48.1	32.7	15.4	51.9

In a first wave of paid experiment we examined the subject pool hypothesis by conducting the Ey and P treatments of E&S with two different subject pools from the University of Munich.⁴ The first subject pool consisted of 109 first year undergraduate students in economics and business administration (henceforth called “economists”), while the second subject pool was made up of 83 first and second year undergraduates from other disciplines, mostly the social sciences (henceforth called “non-economists”). Each subject had to make a decision in both of the distribution games discussed above. The results of these experiments are reported in Table 1. For convenience, we also show the results from the E&S experiments in panel (A) of this table.

The subject pool effects displayed in Table 1 are striking. The Munich economics and business administration students corroborate the main E&S result, confirming that preferences for efficiency play a major role among economists (compare panels A and B of Table 1). 66.1% of the economists opted for the efficient but most inequalitarian allocation A in treatment Ey, even exceeding the 40% in the E&S study. The efficiency advantage of allocation A is somewhat lower in game P, and the fraction of economists opting for the efficient allocation A decreases slightly to 57.8%, very similar to the E&S results. The behavior of non-economists from the University of Munich contrasts sharply with these results, however (see panel C of Table 1). In games Ey and P, the non-economists chose the inefficient but most egalitarian allocation C at the rate of 57.8% and 54.2%, respectively, while only 25-27% opted for the efficient allocation A. The differences between the non-economists and the economists from the University of Munich are statistically highly significant ($p < 0.001$ in each treatment, Fisher exact test).

An additional paid experiment with non-economists (college students) in Zurich, Switzerland, who only participated in treatment P, further confirms the robustness of the subject pool effect. A comparison of panels C and D of Table 1 shows that these students' choices were almost identical to those of the non-economists from the University of Munich ($p > 0.93$, Fisher exact test). Only 22% choose the efficient allocation A, while 55.6% choose the allocation predicted by inequity aversion. The choices of the non-economists in Munich and Zurich also differ significantly from the choices of the E&S subjects ($p < 0.001$, Fisher exact test), further supporting a strong subject pool effect.

⁴ In all experiments reported in this paper, subjects made their decisions anonymously, they were paid in private, and there was no role uncertainty, i.e., the decision makers knew that they were in the role of person 2.

II. The Impact of Political Attitudes on Social Preferences

The strong difference in behavior between economists and non-economists raises the question whether there are other subject pool characteristics that might affect the results. Subjects' social preferences could be related to gender, age, or their political attitudes. One might conjecture that more right wing subjects are less in favor of equality and prefer more efficient allocations than left wing subjects. If this were the case, or if other subject pool characteristics had a significant impact, we would have to worry about whether our subject pool is representative with respect to these characteristics. To address this concern we conducted additional experiments where – after subjects had made their choices in treatments Ey and P – we collected information about their political attitudes and how they voted in the last general election. We also collected information about their age, gender, and their membership in organizations (such as sports clubs or local charities). We recruited 58 third semester students of economics or business administration from the University of Zurich and 100 third semester students from other faculties (law and medicine) and an additional 62 non-economists from outside the university. These last subjects were non-management employees of banks and other financial institutions. They had no college education, but all of them had completed an apprenticeship for their current job.

The subjects' political preferences were elicited in two ways. First, subjects ranked themselves on a scale from 0 to 10 where 0 indicates the most extreme left wing position and 10 indicates the most extreme right wing position. This self-report measure of political attitudes is now widely used in representative surveys in Switzerland. In addition, we asked subjects how they voted in the last national election. Both economists and non-economists participated in these elections at a rate of approximately 70%. For these subjects, we computed a Spearman rank correlation between their self-reported political attitudes on the 0-10 scale and their votes for left, center, and right parties.⁵ This correlation is 0.78 ($p < 0.001$), indicating that subjects' ranking on the left-right scale and their actual voting behavior are consistent.

The results of our new experiments are displayed in panels E and F of Table 1 and in Table 2. We first tested for differences between students from non-economic disciplines and employees. It turns out that the behavior of these two groups is very similar which is

⁵ In these calculations, we treat the social democrats and the green party as left-wing parties, the liberal party (FDP), the Christian democrats (CVP) and the European people's party (EVP) are center parties, and the Swiss people's party (SVP) is a right wing party. This classification is also used by political scientists.

confirmed by statistical tests ($p = 0.775$ in the Ey treatment, $p = 0.739$ in the P treatment, Fisher exact test). Therefore, we pooled their data in panel F of Table 1. The table shows that both in treatment Ey and P, 53.5% of the economists prefer the efficient allocation A whereas only 31% preferred the egalitarian allocation C (see panel E of the table). However, this pattern is reversed among the non-economists (panel F of Table 1). A majority of non-economists (51.9%) prefers the most egalitarian allocation C and only 32.7% choose the efficient allocation A in treatment P. Similarly, a relative majority of the non-economists (48.1%) prefer allocation C in treatment Ey and only 37.7% choose the efficient allocation A.

The differences between economists and non-economists in self-reported political attitudes are small. On average, economists score 5.28 on the left-right scale, whereas the non-economists are somewhat more left wing and score 4.95. This difference is statistically insignificant ($p=0.41$, Mann Whitney test). There is, however, strong individual variation in both groups. It is therefore interesting to examine whether individual differences in political attitude can explain the individual variation in social preferences across subjects.

In Table 2, we report the marginal effects of ordered probit regressions where the choice of the most unequal allocation A is represented with 0, allocation B with 1, and the egalitarian allocation C with 2. As explanatory variables, we included a dummy variable for economists (1 for economist), a gender dummy (1 for women), the political attitude on the left-right scale, age, and a dummy for whether the subject is a member in an organization or club. Regression (1) is based on data from the Ey treatment and regression (2) uses the data from the P treatment. We pool the data from both treatments in regression (3) and control for the potential dependence of subjects' decisions across treatments by clustering on subjects. We also control for a treatment effect in regression (3) by including a dummy for the Ey treatment.

The most important fact stemming from the first three regressions reported in Table 2 is that the marginal effect for the economists' dummy is negative and highly significant even after controlling for political attitudes. In fact, while political attitude has virtually no effect on social preferences, regression (3) shows economists to have an 18 percentage point lower probability of choosing the egalitarian allocation C. Age, membership in organizations, and the Ey-dummy have no significant effects. The gender variable is weakly significant, however, and indicates that women are somewhat more egalitarian. If we average over both treatments (i.e. take regression 3), women are roughly 10 percent more likely to choose the egalitarian allocation C.

TABLE 2 – IMPACT OF SUBJECT POOL, POLITICAL ATTITUDE AND GENDER

Independent variables	Dependent variable: choices in the distribution game (0=allocation A, 1=allocation B, 2=allocation C)					
	New data			All data		
	(panel E and F in Table 1)			(panels B-F in Table 1)		
	(1)	(2)	(3)	(4)	(5)	(6)
	Ey	P	Ey&P	Ey	P	Ey&P
Dummy for economist (1 = economist)	-0.158** (0.069)	-0.198*** (0.069)	-0.177*** (0.060)	-0.258*** (0.043)	-0.242*** (0.043)	-0.246*** (0.038)
Gender dummy (1 = women)	0.066 (0.066)	0.125* (0.066)	0.095* (0.058)	0.091* (0.048)	0.086* (0.045)	0.101** (0.040)
Political attitude (0=left, 10=right)	-0.015 (0.017)	-0.003 (0.019)	-0.009 (0.015)			
Age	0.007 (0.019)	-0.009 (0.019)	-0.001 (0.017)			
Dummy for membership in organizations	0.073 (0.068)	0.108 (0.069)	0.090 (0.059)			
Dummy for Ey-treatment			-0.035 (0.034)			-0.037 (0.025)
Pr (C) if a non-economist	0.518	0.482	0.500	0.530	0.513	0.518
Number of observations	216	216	432	443	407	850
Cluster per Subjects	no	no	yes	no	no	yes
Prob > chi2	0.0072	0.1035	0.0068	0.0000	0.0000	0.0000
Pseudo R ²	0.0362	0.0211	0.0278	0.0391	0.0468	0.0442

Note: The table reports the marginal effects of the different variables on choosing the egalitarian allocation C. Numbers in parentheses denote the standard error of the marginal effects. The marginal effects are evaluated at the point where the dummy for economists is set at zero. The estimated baseline probability of choosing allocation C for non-economists is given in the row “Pr(C) if being a non-economist”. *, ** and *** indicate that the coefficient is statistically different from zero above the 0.1, 0.05 and the 0.01 significance levels, respectively.

We pooled all data from our experiments in regressions 4 – 6 to estimate the overall impact of the economists' dummy and a gender dummy on social preferences⁶. The results of these regressions indicate that economists are approximately 25 percentage points less likely to choose the egalitarian allocation C, while women are more likely to choose C by roughly 10 percentage points. Note also that if we pool the data from both treatments (regression 6) the gender dummy is significant at the 5 percent level.

III. Social Preferences in Strategic Contexts

The E&S experiments all involve dictator games without strategic interaction. This raises the question whether concerns for efficiency play a role in strategic games. A large amount of evidence suggests that concerns for efficiency are dominated in strategic games. The ultimatum game is a striking case in point. Efficiency requires that the responder accepts any positive offer. However, the experimental evidence shows that low offers are frequently rejected. Similarly, efficiency in linear public good experiments requires that players contribute their entire endowments to the public good. While some subjects contribute significant amounts in the first rounds of these experiments, the level of cooperation frequently declines over time. In the final round, a large majority of subjects contributes very little or free rides completely.

We conjecture that there is a fundamental difference between non-strategic and strategic games. We define a strategic game as one where at least two players can affect each others' payoffs by their actions and where there are (partial) conflicts of interest. In these games players tend to see each other as opponents. In a non-strategic game, however, only one player makes a decision that cannot be affected by his opponent. Thus there is no rivalry and a more charitable frame of mind may be triggered. To test this hypothesis we did a control experiment in which economists participated in an ultimatum game prior to playing treatments Ey and P. We conjectured that the ultimatum game might induce the subjects to see each other as opponents when they play treatments Ey and P, rendering the efficiency motive less important. This is indeed what we observed: the choice of the efficient allocation A in game Ey decreased significantly by 25 percentage points and in game P by 15 percentage point if the subjects played the ultimatum game beforehand.⁷ However, these results have to be confirmed by other experiments using different linkages between strategic and non-strategic games in order to better understand what effects are at

⁶ We took all data reported in panels B – F in Table 1. Since we do not have values for age, political attitude and membership in organizations in the experiments reported in panels B – D we cannot use these variables in the regressions 4 – 6.

⁷ In an earlier version of this paper, Fehr and Schmidt (2003b) we report in more detail on this experiment.

work and whether it is possible to generalize social preferences from a non-strategic to a strategic context.

IV. Conclusions

Our experiments indicate that there is a strong subject pool effect in the simple distribution games of Engelmann and Strobel (2004). While a majority of economists prefer efficiency over equity, various groups of non-economists, ranging from students of various other disciplines to low-level employees of banks and financial institutions, show the opposite pattern. On average, more than 50% of the non-economists prefer the most egalitarian (and least efficient) distribution, while the probability of an economist choosing this allocation is 25 percentage points lower. Thus, we conclude that preferences for equity are of major importance in simple distribution experiments, even though there is a significant minority of subjects who seem to be concerned about efficiency. We have also shown that subjects' political preferences do not affect their social preferences for efficiency and equity. Subjects with a right wing political attitude are as likely to choose the egalitarian allocation as left wing subjects. Women, however, favor the egalitarian allocation more often than men do.

References

- Bolton, Gary E. and Axel Ockenfels, 2000. "ERC – A Theory of Equity, Reciprocity and Competition." *American Economic Review* 90 (1), 166-93.
- Engelmann, Dirk and Martin Strobel, 2004. "Inequality Aversion, Efficiency and Maximin Preferences in Simple Distribution Experiments", *American Economic Review* 94 (4), 857-869.
- Fehr, Ernst, and Klaus M. Schmidt, 1999. "A Theory of Fairness, Competition and Cooperation." *Quarterly Journal of Economics* 114, 817-868.
- Fehr, Ernst, and Klaus M. Schmidt, 2003a. "Theories of Fairness and Reciprocity: Evidence and Economic Applications." In: Mathias Dewatripont et.al. (eds.), *Advances in Economics and Econometrics, Eighth World Congress*, Vol. 1, Cambridge (U.K.): Cambridge University Press, 208-57.
- Fehr, Ernst, and Klaus M. Schmidt, 2003b. "The Role of Equality, Efficiency and Rawlsian Motives in Social Preferences", Working Paper No. 179 (<http://www.iew.unizh.ch/wp/iewwp179.pdf>), Institute for Empirical Research in Economics, University of Zurich.