The Role of Desires to Trade on Favorable Terms in Producing the Endowment Effect

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Standard explanations for the endowment effect emphasize loss aversion and ownership. The current research investigates another possibility: that price discrepancies between owners and non-owners might be influenced by desires to trade on favorable terms. We test this by eliciting valuation in non-trading contexts, where we find the endowment effect disappears.

[to cite]:

[url]:
http://www.acrwebsite.org/volumes/1019899/volumes/v43/NA-43

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EXTENDED ABSTRACT

Standard explanations for the endowment effect suggest that product owners are either averse to the loss of their product (and therefore demand more to give it up) (Kahneman, Knetsch, and Thaler 1986, 1991) or that ownership of the product imbues it with some additional value due to its association with the self (Dommer and Swaminathan 2012; Morewedge et al. 2009; Shu and Peck 2011). The current research investigates another possibility: that price discrepancies between owners and non-owners might be importantly influenced by the desire to trade on favorable terms. Specifically, we suggest that, when in a trading position (i.e., exchanging the product for money or vice versa), individuals will only agree to trade if they are sufficiently motivated to do so. We predict that they do this by setting prices at which they would be happy to trade. Trading non-owners (buyers) can do this by setting maximum WTP below what the product is actually worth to them. Trading owners (sellers) can do this by setting minimum selling prices above their subjective valuation. In short, we suggest that traders’ prices are not those at which they are indifferent between trading and not trading, but are, in fact, prices at which they would prefer to trade. Across three studies, we test this idea by comparing valuation in trading and non-trading contexts.

Study 1

Ninety-three students participated in a 2 (Owner vs. Non-Owner) x 2 (Trading vs. Non-Trading) between-subjects design. Participants were first endowed with a product (a chocolate bar) or not (Ownership). Trading conditions were identical to standard buyer/seller conditions. In the Non-Trading conditions, non-owners were identical to “choosers” in previous research (i.e., they chose between receiving money or the product). In contrast, non-trading owners were told they would have to choose between losing money and losing their chocolate bar. This is a novel condition that puts owners in an objectively identical condition to buyers, but which should not be construed as trading. All participants indicated product valuation using an identical incentive compatible procedure. Our primary prediction was that the difference between owners and non-owners would be reduced when not trading.

A main effect of Ownership on valuation revealed the standard endowment effect ($M_s = $2.52 vs. $1.94; F(1, 89) = 4.08, p < .05). This was qualified, however, by a significant Ownership by Trading interaction ($F(1, 89) = 30.62, p < .001). Consistent with prior research, sellers valued the product more than buyers ($M_s = $3.63 vs. $1.46; $F(1, 89) = 30.18, p < .001). In contrast, non-trading owners – who had nevertheless been endowed with the product – valued it less than non-trading non-owners ($M_s = $1.40 vs. $2.40; p < .05) in a complete (unexpected) reversal of the endowment effect. Note that non-trading owners also valued it no more than buyers ($M_s = $1.40 vs. $1.46; p > .60). This is an important comparison because both of these groups were in objectively identical positions.

Study 2: Removing a Confound

The purpose of Study 2 was to replicate the previous finding and to examine the unexpected reversal. One possibility was that we may have inadvertently caused non-trading owners to construe their situation as that of a buyer (note that we should still have seen the effects of loss aversion/ownership, which we did not). To address this, we repeated the previous design, adding one condition, leading to a 2 (Ownership) x 3 (Trading: Trading, Non-Trading, Forfeiting) between-subjects experiment. Non-Trading conditions were identical to the previous study. In the Forfeiting conditions, participants were asked how much less than $5 they would be willing to receive in order not to lose their chocolate bar (owners) or to receive a chocolate bar (non-owners). This was designed to prevent owners, in particular, from re-construing their circumstances as buyers. We used the same incentive compatible procedure in all conditions.

We replicated exactly the findings from Study 1: trading owners (sellers) valued the product more than trading non-owners (buyers) ($M_s = $2.52 vs. $1.21; $F(1, 192) = 21.25, p < .001). Non-trading owners valued the product less than non-trading non-owners, as per the previous experiment ($M_s = $1.90 vs. $1.82; $F(1, 192) = 12.39, p < .001). Most importantly, there was no effect of ownership in the new Forfeiting condition ($M_s = $1.98 vs. $1.69; F < 1), consistent with predictions.

Study 3: Converging Evidence

The final study provided another test of trading motivation, but also kept all participants in objectively identical positions (unlike our previous studies). First, we compared the standard seller/chooser comparisons that have been used to demonstrate endowment, and which put participants in objectively identical positions. We argued that the standard chooser conditions should not involve any trading motivation, but that seller conditions would. In order to remove the trading motivation from sellers (yet keep owners and non-owners in otherwise identical positions) we put owners and non-owners in a second condition in which we elicited valuation by telling participants that they would randomly win an amount from the list (the same list of amounts used in the previous studies). Non-owners were told they would have the choice of forfeiting their winnings in order to receive a chocolate bar, and that they should indicate what they would do for each amount on the list ($0-$4 in 25c increments as in all studies). Owners were told they could only keep their winnings or the chocolate bar (but not both), and should indicate their choice for each amount. This resulted in a 2 (Ownership) x 2 (Receive vs. Win) between-subjects experiment in which all participants were in objectively identical positions.

There was a significant interaction on product valuation ($F(1, 135) = 5.79, p < .05). Follow-up analyses revealed the standard endowment effect when comparing sellers to choosers (i.e., the effect of ownership in the “receive” conditions) ($M_s = $2.34 vs. $1.48; $F(1, 135) = 15.99, p < .001). However, there was no detectable effect of ownership in the win conditions ($M_s = $1.57 vs. $1.40; $F < 1). Owner and non-owner valuation in the win conditions were also no different than valuation in the chooser conditions ($M_s = $1.57 and $1.40 vs. $1.48; $F < 1), consistent with the idea that all three conditions lacked a trading motivation.
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