

## PROMOTING HONESTY IN NEGOTIATION: AN EXERCISE IN PRACTICAL ETHICS\*

Peter C. Cramton and J. Gregory Dees

**Abstract:** In a competitive and morally imperfect world, business people are often faced with serious ethical challenges. Harboring suspicions about the ethics of others, many feel justified in engaging in less-than-ideal conduct to protect their own interests. The most sophisticated moral arguments are unlikely to counteract this behavior. We believe that this morally defensive behavior is responsible, in large part, for much undesirable deception in negotiation. Drawing on recent work in the literature of negotiations, we present some practical guidance on how negotiators might build trust, establish common interests, and secure credibility for their statements thereby promoting honesty. We also point out the types of social and institutional arrangements, many of which have become commonplace, that work to promote credibility, trust, and honesty in business dealings. Our approach is offered not only as a specific response to the problem of deception in negotiation, but as one model of how research in business ethics might offer constructive advice to practitioners.

...there is such a gap between how one lives and how one ought to live that anyone who abandons what is done for what ought to be done learns his ruin rather than his preservation...

—Niccolo Machiavelli

We must make the world honest before we can honestly say to our children that honesty is the best policy.

—George Bernard Shaw

**I**F business ethics is to have a significant impact on business practice, many of us working in the field will need to take a more pragmatic approach to our craft (Dees and Cramton, 1991). Our work should help ethically sensitive business people establish stable institutional arrangements that promote and protect ethically desirable conduct, and it should help individuals to develop strategies for effective ethical behavior in a competitive and morally imperfect world. This paper is offered as one model of more practical business ethics

To illustrate the model we have selected the topic of deception in negotiation. Negotiation is a pervasive feature of business life. Success in business typically requires successful negotiations. It is commonly believed that success in negotiation is enhanced by the skillful use of deceptive tactics, such as bluffing, exaggeration, posturing, stage-setting, and outright misrepresentation. As White (1980, p. 927) candidly states, "The critical difference between those who are successful negotiators and those who are not lies in this capacity both to mislead and not to be misled." Some shrewd practitioners have advanced the art of deception beyond prudent concealment of preferences to more aggressive forms of strategic misrepresentation.<sup>1</sup>

Given the high value placed on honesty, the incentives for deception in negotiation create a serious moral tension for business people, as well as a public relations problem for business. The public relations problem is not new. In ancient Athens, Hermes, a trickster who stole his brother's (Apollo's) cattle on the day he was born and later lied about it, was the patron god of merchants. Anacharsis wrote in 600 B.C., "The market is the place set apart where men may deceive one another."

Not surprisingly, deception in negotiation is a widely discussed problem in business ethics. However, much of the attention has been devoted to the question of when (if ever) various deceptive tactics are ethically justified. Many writers have been highly critical of deception in business. Others, most notably Carr (1968) in his controversial piece on business bluffing, have argued that business has its own ethics, one that permits a wide range of deceptive practices that would not be acceptable outside of business.

We see little benefit from joining this debate. It is not our intent in this paper, nor was it our intent in Dees and Cramton (1991). Boatright's suggestion (1992) that our "mutual trust perspective" on practical ethics might best be understood as a two-tiered Hobbesian theory about the justification of deception misses our central point. We were not staking out a philosophical position, but rather attempting to articulate a deep-seated view reflected in the attitudes and behaviors of many negotiators with whom we have had experience. The point was to provide a backdrop for developing practical recommendations that negotiators might actually take up. Debating the possible philosophical justifications for different types of deception is intellectually engaging, but unlikely to have a direct impact on practice. How many negotiators would change their behavior when it is pointed out that their views are essentially Hobbesian and that Kant, who is regarded as a superior moral philosopher, would find them objectionable? Even if this claim were accompanied by a philosophical refutation of Hobbes and an explanation of Kant's categorical imperative, it seems doubtful that much negotiating behavior would change.

We also avoid the standard debate because it focuses too much attention on justification, obscuring the fact that behavior may be justified, but nonetheless regrettable. A dramatic example is the killing of civilians during a war, even a just war. In some instances, it may be justified, but even when justified, it is regrettable. Rather than engaging in (perhaps unresolvable) philosophical debates about the exact conditions under which the killing of civilians is justified, it seems that one who is concerned about the loss of civilian life in war would be better served by putting resources and intellectual energy into developing political, economic, diplomatic, and military strategies that reduce the risk to innocent civilians.

Our premise is that, outside of a few recreational contexts, deception is a regrettable feature of business negotiations, even when it is justified (or common-place).<sup>2</sup> Machiavellian gap between what is done and what (ideally) ought to be done is real when it comes to deception in business negotiations. A purely moralistic (or philosophical) response is likely to be ineffective. A Machiavellian response is likely to make things worse. In the spirit of Shaw, we prefer to explore means of constructively narrowing the gap, thereby making the world more honest.

### *Ethics, Opportunism, and Trust*

In an ideal world, people would do the right thing simply because it is right. In the world in which we live, morality is more complex. People often disagree about what is right. Even when a consensus on moral values is reached, many find that they do not consistently live up to moral standards. One reason for short is that most people place a high value on their own welfare. They may have moral ideals and commitments, but concern about personal well-being is a powerful motivating factor. It is more powerful for some than it is for others, but few can claim to be indifferent to it. Any significant gap between the demands of ethics and the urging of self-interest, narrowly defined,<sup>3</sup> creates incentive problems for individuals and for societies wishing to maintain high ethical standards. The problems arise on two levels.

At the first level are the direct incentive problems of opportunism and desperation. Problems of opportunism arise when individuals willingly violate ethical norms in order to pursue opportunities for private gain. They yield to temptation. Problems of desperation arise when individuals violate ethical norms to avoid personal loss or hardship. Even if we grant that most people place some intrinsic value on doing the right thing, as they see it, sometimes the risk or the temptation is just too great. Philosophers refer to this problem as “weakness of the will.” Weakness of the will is not limited to moral deviants. Too often we are presented with evidence from our daily lives, from news stories, and from academic research,<sup>4</sup> that well-educated, apparently normal individuals can be tempted or pressured into compromising ethical standards.

The effects of opportunism and desperation are magnified by a second-level problem concerning trust and fair play. One of the reasons people are willing to behave ethically, even when their personal welfare is at risk, is that they expect others to behave likewise. It seems unfair for individuals with weaker ethical commitments to prosper materially, especially at the expense of individuals with stronger commitments. An atmosphere of mutual trust appeals to play an important role in grounding ethical behavior for many people.<sup>5</sup> Suspicion that others are profiting from misconduct can destroy that atmosphere and spoil the sense of satisfaction that might be gained from principled behavior. A sense of fair play can motivate individuals with strong ethical commitments to engage in what they would otherwise consider unacceptable behavior.

Individual integrity and social stability are difficult to maintain in a social setting in which there is serious conflict between ethics and personal welfare. Traditionally, moral philosophers have responded to this conflict in one of two ways. Some, particularly Kantians, acknowledge the gap between ethics and self-interest, but assert on philosophical grounds the dominance of moral considerations over those of personal welfare. Others argue that the gap is only apparent. By refining the definition of self-interest, they attempt to reconcile ethics and self-interest (Kavka, 1984). As philosophically interesting as these views are, neither holds much promise of improving conduct. Practical, not conceptual, solutions are needed.

### *Incentive for Deception in Negotiation*

To illustrate the practical approach to ethical incentive problems, we have chosen to concentrate on the phenomenon of deception in negotiation. Negotiation offers a familiar setting in which individuals often feel a tension between ethics and self-interest. In particular, individuals frequently face a temptation to deceive the other party, in hopes of bettering the outcome for themselves.

We adopt the following definitions:

A *negotiation* is any situation in which two or more parties are engaged in communications, the aim of which is agreement on terms affecting an exchange, or a distribution of benefits, burdens, roles, or responsibilities.

*Deception* is any deliberate act or omission by one party taken with the intention of creating or adding support to a false belief in another party.<sup>6</sup>

*Honesty* is the absence of deception.<sup>7</sup>

Notice that lying is only one tactic that may be used to deceive a negotiation partner. Lying, strictly interpreted, requires making a false statement (or at least a statement believed to be false by its maker). The clever manipulation of verbal and non-verbal signals to create or support a false impression, without making a false statement, also counts as deception. Likewise, concealing information is a deceptive tactic if and only if the concealment is intended to create or support a false belief. In some cases, there is a fine line between allowing the other party to continue to hold a false belief and adding support to that belief.

To understand the incentives for deception in negotiation, we use some basic game theory<sup>8</sup> and a fictional world called Metopia. The simplified world of Metopia allows us to put aside temporarily some of the complexity of the real world, in order to analyze the incentives for deception. Metopia is a world much like ours, but populated exclusively with rational, self-centered individuals. We adopt the standard definition of self-interest from economics.

An action is in a party's *self-interest* if, given the party's beliefs at the time of decision, the action yields greater expected utility for the party than any other available action.

Metopians always act in their self-interest. Their interests are even more self-centered and material, focused on their own personal welfare. Metopians' preferences are independent of the preferences of others. They have no specific preferences about the process of the negotiation. In particular, Metopians do not have an independent preference for honesty or dishonesty in the process of negotiation. They feel no guilt about deception, nor do they enjoy fooling others. Metopians have no interest in the opinions of others, except to the extent that such opinions are likely to inhibit or enhance their ability to satisfy their self-centered interests. Finally, Metopians do not have any religious belief system that provides moral rewards and punishments. These features characterize the narrow conception of self-interest in Metopia.

#### *Opportunities for Deception in Metopia*

The basis for deception in Metopia is the presence of (real or perceived)<sup>9</sup> informational differences among the parties. Negotiators often have private information about the item under discussion, about their ability and willingness to take future actions, and about their own settlement preferences. Private information, however, does not always present a profitable opportunity for deception. Often it is more prudent to be honest. In general, an opportunity for *A* to profitably deceive *B* arises only when *B* believes *A* has information that is of value to *B* in determining *B*'s negotiating position, *B* knows of no other cost-efficient way to get the information before making a commitment, and it is to *A*'s advantage if *B* acts on false beliefs about the matter. The opportunity will depend in part on the kind of information in question.

*Deception About the Matter Under Negotiation.* It is common for at least one of the parties to have privileged access to information about the subject matter under negotiation. In an exchange, often the seller has the information advantage. The classic example is the seller of a used car who knows more about the history and mechanical condition of the car than the buyer. Sometimes, however, the buyer has an advantage over an unsophisticated or uninformed seller. An example of this would be an art dealer buying a dusty old painting at a garage sale, or a real estate developer buying parcels of property for an unannounced development project. In a barter situation, both parties may have informational advantages about their side of the exchange. Information asymmetry is not limited to product exchanges. It is also common when the negotiation is about a service to be delivered, a benefit (or burden) to be distributed, or a right (or responsibility) to be assigned.

Even in Metopia, where negotiators recognize the other party's incentives to deceive, the possibility of deception can cause serious problems. For example, suppose a seller has private information about the quality, broadly interpreted, of the good being sold. The higher the quality, the more the good is worth to the buyer, and consequently the more the buyer is willing to pay. In a one-shot situation the seller has an interest in overstating the product's quality. If the seller is believed, she can get a higher profit by overstating, assuming it is more costly to produce high quality goods than low quality goods. A Metopian buyer, therefore, will not believe statements that the good is of high quality, even when it is. Thus, the incentive to deceive about quality leads to Akerlof's (1970) "market for lemons." The buyer, not believing statements of high quality, is only willing to pay a low quality price. The seller is only willing to produce low quality goods, even if both are better off with the exchange of high quality goods at a high quality price.

*Deception About Future Actions.* Statements about future actions play a key role in many business negotiations. Such statements fall into two categories: threats, and promises. Each of these presents an opportunity for deception about one's true intentions.

Threats are often used to place pressure on the other party to settle. They range from the simple threat of walking away from the negotiation to threats of causing harm to the other party. For instance, in a labor negotiation, management may threaten to close a plant if the union does not make concessions. Threats can be bluffed, but for a bluffed threat to work, it must be credible. Suppose *A* threatens *B*. The threat is credible if *B* thinks that it is in *A*'s interest to carry out the threat if *B* does not comply. The success of the threat, then, depends on how well *B* can assess *A*'s true incentives. In the above example, if labor does not have information about plant-by-plant profitability, management may get concessions by threatening to close the plant. *B* may not be able to tell a bluffed threat from a real one. Legitimate threats and warnings may be robbed of their informational content. Even if management offered to present labor with the financial information, labor would recognize management's incentive to present deceptive information. Without a reliable source of information, *B* may have to discount all of *A*'s threats, legitimate or bluffed.

Promises are an essential element in most negotiations. Often one party performs, or makes an investment before the other. Even if the central exchange appears to be simultaneous, there may be understandings and expectations about future actions. Sellers may promise to protect buyers in certain contingencies, for instance, allowing the buyer to return clothing that does not fit. On the other hand, buyers may ask for credit and promise to pay sellers at a later date. In any case, a party making a commitment is likely to know much more about the probability of compliance than the party to whom the commitment is made. For instance, a computer manufacturer who is planning to go out of business, but wants to sell as much of her remaining stock as possible, might continue to offer a warranty that she knows she will not be in a position to honor. Again, lack of information about the true incentives, abilities, and resources of *A*, the party making the commitment, makes *B* vulnerable to deception. When *A* has an incentive to deceive, even *A*'s good faith promises are not believed. It is difficult for *A* to credibly reassure *B* of *A*'s willingness and ability to fulfill the promise.

*Deception About Settlement Preferences.* The third area of opportunity for deception in Metopia involves the settlement preferences of the negotiating parties. Settlement preferences include the negotiator's reservation price, time pressures, and the different values the negotiator places on specific terms of agreement. Sometimes it is useful to share these preferences, if the sharing does not make one vulnerable to exploitation by the other. Yet, often, negotiators find it in their interest to misrepresent their preferences. They may want to conceal a weak bargaining position, or to give the appearance of making a concession when they are getting what they want.<sup>10</sup> It is possible for the other party to gather indirect evidence about these matters. For instance, if house buyer, *B*, discovers that house seller, *A*, has accepted a job in another part of the country and has made a deposit on a house there, this points to *A*'s eagerness to sell. If rug seller, *A*, sells many of the same rugs, rug buyer, *B*, may be able to get a history of the prices *A* has accepted in the past as an indicator of how low *A* is willing to go. Nonetheless, individual negotiators generally have privileged access to information about their own settlement preferences.

To see why uncertainty about settlement preferences may lead to deception imagine the negotiation process between two traders, *A* and *B*, where each party is uncertain about the strength of the other's bargaining position. Neither trader knows the other's values or outside opportunities, or how these values and opportunities change as time passes. The negotiation consists of a sequence of offers and counteroffers until someone finally accepts the other's offer. Agreement occurs at a point where the further benefits of bargaining (improved terms of trade) do not seem worth the costs to secure them (delayed agreement or a risk of disagreement). The parties bargain until the marginal cost of continuing exceeds the marginal benefit. *B*'s net gain of continuing is based on her expectation about *A*'s future concessions, which, in turn, is based on *B*'s belief about (the strength of *A*'s bargaining position. To do well, *A* would like to persuade *B* to accept *A*'s most recent offer by convincing *B* that only slight concessions will be made in the future. A natural justification for slight concessions in the future is a strong bargaining position—good outside opportunities and a lack of eagerness to reach agreement. Hence, *A* benefits from convincing *B* that her bargaining position is stronger than it truly is. *A* has an incentive to deceive *B* about any facts, beliefs, or values that might expose the weakness in *A*'s position.

For this reason, bargainers in Metopia are skeptical of information that the other party presents that bears on that party's settlement preferences. This has its costs. To convince *B* of the strength of her position, *A* must take actions that a weaker *A* would not want to imitate, such as delaying agreement or risking disagreement, both of which involve bargaining inefficiencies. Indeed, so long as there is some uncertainty about whether gains from trade exist, some bargaining inefficiencies must occur regardless of the bargaining process adopted, if the parties act in their own self-interest and have only costly means of signaling strength.<sup>11</sup>

*Factors Inhibiting Deception in Metopia*

One might think that Metopia would be riddled with attempted deception and bad faith, since Metopians exploit opportunities to misrepresent information in a negotiation. However, as Adam Smith observed, “The most notorious liar...tells the fair truth at least twenty times for once that he seriously and deliberately lies” (1759, p. 530). The same might be said of Metopians. Several mechanisms work to inhibit deception. Metopians would rationally invest in processes and mechanisms to protect themselves from deception and its untoward social consequences. Even potential deceivers recognize the effect that the possibility of deception has in undermining even their true statements. To create a climate of confidence that would facilitate negotiations, Metopians would investigate claims, construct contractual mechanisms to enforce honesty, and work to ease the availability of reputation information.

*Ex Ante Verification.* One remedy for the risk of deception is to verify claims and assumptions before making commitments that depend on those claims or assumptions. Negotiators could gather independent evidence themselves, or they might hire others to do it. Gathering it themselves is, generally, the most reliable method. However, an individual negotiator does not always have the expertise to verify claims efficiently. Accordingly, just as the use of house inspectors has become commonplace in residential real estate transactions, Metopians would employ auditors, testers, inspectors, and private detectives to verify the truth of claims made or implied in negotiations.<sup>12</sup>

One problem is that verification of every significant claim made in a negotiation would be quite costly. Often, it would not be justified. Metopians would be creative in reducing the costs of verification. Two mechanisms for doing so are the use of economies of scale and random verification. It would be highly inefficient, for instance, for everyone buying a refrigerator to hire a private inspector to evaluate different models. However, because refrigerators are standard products, we would expect to see information gathered by a third party who would sell it to those who need it. When economies of scale are not possible, Metopians could adopt random verification procedures to lower verification costs. This would work so long as the parties caught in a deceptive act could be punished harshly. For example, if the maximum penalty that *A* could apply to *B* is ten times *B*'s individual net gain from deceiving *A*, then *A*'s verifying information one out of ten times is sufficient to prevent deception by *B*. Verification is economical in this case, so long as the cost of verification is no more than ten times the net efficiency gain from honest behavior.

*Contractual Mechanisms.* Unfortunately, even with some creativity, ex ante verification is limited. Some claims are simply too difficult, or too costly to test ex ante with any confidence. Claims about the long-term reliability of a new product typically fall into this category, as do many claims about actions to be taken in the future and about settlement preferences. In such cases, Metopians would develop contractual mechanisms to add credibility to claims made or implied in a negotiation.

Ideally, the mechanisms would be self-enforcing. However, such mechanisms are limited in their applicability, and may be more costly than alternatives, even though the alternatives require third-party enforcement. Consequently, we would expect to find in Metopia systems of third-party enforcement and a high level of explicit contracting. The third-parties could play a variety of roles from holding collateral to adjudicating disputes and exacting settlements. Metopia would benefit from an analogue to our court system, with coercive authority. Although complete contracts in many negotiations would be impossible to write, because of unforeseen contingencies, Metopians vulnerable to deception would press for clarity on important matters. Explicit claims are more easily verified to third-parties. Ambiguity and vagueness make enforcement problematic.

1. Warranties are one type of contractual device that would be used in Metopia to handle matters that are not subject to ex ante verification.<sup>13</sup> Warranties can be used to add credibility to claims about the item under negotiation that cannot be reliably or cost-effectively assessed until after the deal is struck. “Defective products will be replaced or repaired at the manufacturer’s expense.” They also can be used to make explicit and reinforce promises of future performance. “If we ever fail to plow the snow from your driveway before 7 am, your full year’s service contract is free.”<sup>14</sup> They can even provide some assurance regarding settlement preferences. “If we sell this item to anyone at a lower price within six months, or if you can find another dealer who will beat our price on the item, we will pay you double the difference.”<sup>15</sup> Metopians would use warranties to shift the risks inherent in a negotiation from the recipient of the warranty to the provider of the warranty.

It is not easy to write an enforceable and cost-effective warranty in Metopia. To be enforceable, it needs to clearly specify the conditions under which it applies, the remedies available to the recipient, and the process for bringing the remedies about. Otherwise, it invites costly and hard-to-resolve disputes between self-interested Metopians. Cost-effectiveness depends on the nature of the warranty’s specific provisions, the

ability and the incentives for the provider to make good, and tendencies for opportunistic behavior on the part of the recipient. For instance, a manufacturer's warranty that allows for replacement or repair only when a manufacturing defect is detected may not be very effective in cases where it is difficult to determine whether a discovered defect is due to poor manufacture, or misuse of the product by the buyer. A warranty that requires that the product be returned in person to a remote regional service center for lengthy evaluation and repair could well make the transaction costs involved in seeking remedy under the warranty so high as to make its application a non-issue. Likewise wise, a product service contract offered by a company with limited financial resources and a significantly understaffed service department provides little value to the buyer. On the other hand, an unconditional warranty of consumer satisfaction that is easy to invoke and offers generous remedies (e.g., satisfaction guaranteed, or all your money back, no questions asked) is likely to create opportunistic behavior on the part of self-interested Metopian consumers. They will buy products, get some valuable use out of them, and then make warranty claims.

Despite these difficulties, Metopians would work hard to construct enforceable and cost-effective warranties to secure their transactions, provide credibility to their claims, and reduce incentives for opportunism. Nonetheless, at its heart, a warranty is just another promise. Its credibility, in a Metopian world, rests on the availability of other enforcement mechanisms and on reputation effects (to be discussed shortly).

2. Bonds. Promises, including warranties, often need further reinforcement to be credible. Even if the promisor makes the promise in good faith, incentives can change before the promise is carried out. How can the promisee be reasonably confident of performance? Another way to provide credibility to claims about future action is to put in place mechanisms that will reinforce the promisor's incentives for good faith *ex ante* and compliance *ex post*. This can be done by posting a bond.

Posting a bond involves doing something at the time the deal is struck that allows the other party, or a third-party to either exact a penalty from a negligent promisor, or compensate the harmed promisee, if the promise is not kept. The most common form of bonding mechanism is collateral. The promisor gives the promisee, in effect, a contingent claim on some of the promisor's assets. If the promise is not fulfilled, the assets revert to the promisee. In some cases, the promisee will hold the assets until the promise is fulfilled, but this need not be the case if a credible third-party can enforce the asset transfer when nonperformance is verified.

What if the promisor does not have assets to compensate the promisee for nonperformance? One way of handling this would be through insurance schemes. An insurer would evaluate promisors and charge a premium based on the insurance company's assessment of the probabilities of default. The insurer would pool premiums from a number of promisors to provide enough funds for paying expected claims. Such a scheme would have to be constructed carefully to avoid the problems of adverse selection and moral hazard. Another alternative for dealing with the problem of limited assets is the use of hostages. The agreement can be reinforced as long as the promisor has assets that she values as much as noncompliance with the promise. Hostages are items of value to the promisor that may not have value to the promisee. The incentive for compliance is the threat to destroy or transfer the hostages.

Creating the right bonding agreement is also difficult in Metopia.<sup>16</sup> A bond that requires too little from the promisor will result in nonperformance. A bond that provides too much value to the promisee may lead to a false claim of nonperformance, especially if the promisee is holding the collateral. Even with independent parties adjudicating disputes, it will be difficult to get the incentives just right for all three parties. Much rests on the reputation of the third party and on the clarity of conditions for nonperformance. Nonetheless, we would expect to find Metopians constructing a wide variety of bonding arrangements to off-set the problems raised by incentives to deceive.<sup>17</sup>

Contractual mechanisms, such as warranties and bonds, have limited application. In some cases, it will be impossible for Metopians to contract on relevant future actions. One reason it may not be possible is that one party's action may be unobservable to the other. Hence, the party may make false claims about the unobservable action. For example, a consultant may be hired to complete a project that has uncertain time requirements, promising to work hard to complete the project in the shortest possible time. If the consultant's effort is unobservable to the client, the consultant may have an incentive to renege on the promise of concerted effort. Likewise, a group sharing a common resource may agree to use the resource efficiently, but if the group cannot monitor individual use of the resource, individuals may overuse it. The difficulty of verifying compliance may make it impossible to write a contract that induces the efficient level of effort (Holmstrom, 1979). Even if it is possible to write a complete contract, it may prove too costly to enforce the contract, because the actions—while observable to the deceived party—may not be easily verified to the third-party attempting to enforce the contract. Furthermore, the effective application of contractual mechanisms often requires an independent third-party with the right incentives. Finally, these mechanisms can be costly. They can complicate contract writing, tie up assets that could be profitably used elsewhere, and

divert value to third parties who must be paid. If not constructed with great care, these contractual mechanisms can create new incentives for deceptive behavior.

*Reputation Effects.* To supplement ex ante verification and contractual mechanisms, Metopians would need to rely on reputations effects to induce honesty.<sup>18</sup> A person’s reputation affects future opportunities by influencing the other’s belief about what the person will do in the future. A negotiator with a reputation for being deceitful is likely to be disadvantaged in future negotiations. She may have a hard time finding negotiating partners and when she finds them, they will be on their guard. This is not because Metopians are morally offended by deceit. It is simply that negotiations tend to go better, other things being equal, when one is dealing with a person who has a reputation for honesty to maintain. Thus, when deciding to deceive, a Metopian negotiator must consider not only the short-run consequence of the decision, but also how the decision affects her reputation and hence future negotiations.

Adam Smith (1759, p. 350) was aware of the power of reputation, commenting, “The prudent man is always sincere, and feels horror at the very thought of exposing himself to the disgrace which attends upon the detection of falsehood.” Smith overstates the case. An intelligent Metopian will know that some attempts at deception pose greater risks to one’s reputation than others. Reputation works best when claims are explicit, ex post detection is likely, and information about deceptive practices can be credibly communicated to the culprit’s future negotiating partners.

1. Reputations in On-Going Negotiations Between Two Parties. The setting in which reputation is most likely to be effective is that of two parties, *A* and *B*, who negotiate repeatedly over time. Suppose both parties have an incentive to deceive if a particular negotiation is considered in isolation. The incentive problem in an isolated negotiation is captured by the following Prisoner’s Dilemma game:

		<i>B</i> ’s Choice	
		Honest	Deceive
<i>A</i> ’ Choice	Honest	2, 2	0, 3
	Deceive	3, 0	1, 1

Each cell in the matrix gives the payoffs to *A* and *B*, as a function of their choices. In this highly stylized representation, both parties decide independently whether to adopt a negotiation strategy based on open and honest communication or a strategy of deception. If both are honest, they find a point on the Pareto frontier that is both equitable and efficient (each gets 2). If both deceive, equity is preserved but efficiency is sacrificed (each gets 1). Finally, if one deceives an honest person, the deceiver gets the maximum payoff (3) and the honest person gets the worst payoff (0). A Metopian in the one-shot negotiation would choose to deceive, since it is a dominant strategy—deception is the preferred choice regardless of what the other person does. But if the parties face each other repeatedly in subsequent negotiations, the incentives change.

To see how reputations can work in our example, imagine that after each negotiation there is a probability *p* that the relationship will continue for at least one more period.<sup>19</sup> In such a setting, each party can adopt a reputational strategy that supports honest behavior, such as the following: “I will be open and honest so long as you reciprocate with honest behavior, but if ever you deceive me I will be deceitful forever after.” Such a harsh and unforgiving strategy (Friedman, 1971) will prompt honest behavior provided the long-run benefit from honest behavior exceeds the short-run benefit that can be gained by deceiving an honest party. Assuming *B* is following the strategy above, *A* can get 2 in each period by being honest; whereas, deceit would result in a payoff of 3 in the current period and a payoff of 1 in all future periods. *The payoff from honesty then is*  $2(1 + p + p^2 + \dots) = 2/(1-p)$ ; *the payoff from deceit is*  $3 + (p + p^2 + \dots) = 3 + p/(1-p)$ . It is better to be honest than to deceive so long as  $2/(1-p) \geq 3 + p/(1-p)$ , or  $p \geq 1/2$ . So long as there is at least a 50% chance that the parties will meet again, they are able to support honest behavior. The short-run benefit from deceiving an honest party is insufficient compensation for destroying a reputation for honesty.<sup>20</sup>

This story relies on the assumption that deception is uncovered after each negotiation and before any further encounters. What if deceptions are only occasionally observed? Can we still motivate honesty as self-interested behavior? The answer (and analysis) is roughly the same as before: honest behavior can be sustained, provided it is sufficiently likely that the parties will meet again and it is not too unlikely that a deception will be observed. Suppose each deception is detected with probability *d*. Is honesty better than a one-period deception? Honesty yields 2 in every period for an expected payoff of  $2/(1-p)$ ; whereas, a one-period deception results in 3 in the current period and then either 1 or 2 thereafter, depending on whether the deception was detected, resulting in an expected payoff of  $3 + p[d/(1-p) + (1-d)2/(1-p)]$ . Simplifying, we find that honesty is better than deception, so long as  $p \geq 1/(1+d)$ . If there is a 50% chance of detection, then there

must be a  $2/3$  chance of meeting again; if there is a 10% chance of detection, the continuation probability must be at least  $10/11$ .

More interesting is the case where only a noisy signal of deception is observed. Reputations can help in this situation of imperfect observability. However, some punishment must take place even if no one is actually deceptive. Since deception cannot be distinguished from bad luck, *both* bad luck and deception must be punished. This unjust punishment might offend moral sensibilities in the real world, but Metopians would freely use it if it worked. One possible strategy is as follows: “If it is sufficiently likely that you have been honest in the last period, I will be honest this period; otherwise, I won’t trust you for the next several periods, and then will revert to honesty.” For a given continuation probability and level of noise in the observations of honesty, it is possible to specify exactly what “sufficiently likely” and “several” must be in order to support honesty as an equilibrium with this strategy.<sup>21</sup> There is some efficiency loss, since punishments occasionally are called for. However, to the extent that the continuation probability is large and the noise in observing defections is small, the efficiency loss will be small as well.

Continuing relationships provide an effective environment for using reputations to deter deception. However, we should note one limitation of this analysis. It assumes that the continuation probability is a given. But in fact a party’s decision whether to continue the relationship may depend on what happened in the past. If there is a particular negotiation with unusually large stakes, it might make sense for a Metopian negotiator to adopt a “take the money and run” strategy: deceive the other and then move on to other things. This is precisely the strategy used by a double agent engaged in espionage (Sober, 1985). For a time, the spy must gain the confidence of her superior by supplying accurate information, but when the value of deception is highest, the spy will double-cross her superior and move on.

2. Reputations Where Only One Party Has a Continuing Market Presence. Our story so far requires that the parties in the negotiation continue to interact with each other for an indefinite period. This seems plausible in a number of situations, such as negotiations between a firm and a regular supplier, or between a manager and her immediate subordinate, but there are numerous situations where only one party is likely to be susceptible to reputation effects. This happens when one party continues to play an active role in a market but does so with many one-shot (or infrequent) negotiating partners. A retail car dealer is an example of what we call an enduring negotiating party. The typical car buyer does not make car purchases frequently enough to develop much of it reputation. The dealer, however, provides an enduring presence to which a reputation can adhere.

Do reputation effects still work to induce honesty in these Metopian negotiations? They do only if the party that endures is also the party with the greatest opportunities for deception, and there is an efficient mechanism for conveying information about the enduring party’s reputation in a credible way to future negotiating partners. In such cases, the threat of losing a good reputation prevents the enduring party from exploiting the other.

What if there is also some risk of the non-enduring party engaging in deception. For instance, the car buyer might pay for the car with a bad check. In our example of a one-shot negotiation, modelled as a Prisoner’s Dilemma, both parties are at risk—each may be deceived by the other—so both parties must endure, if reputation effects are to inhibit deception. If only one party endures, then nothing is to stop the non-enduring party from deceiving the enduring party. As a defensive measure, the enduring party might be forced to be deceptive as well. However, this undesirable result can be avoided if we modify the example so that the non-enduring party moves first (or equivalently, that the non-enduring party’s behavior is verifiable *ex ante*). For instance, the car clearer would not deliver the car until the buyer’s check cleared the bank. In this case, the enduring party *B* is facing a sequence  $\{A_1, A_2, \dots, A_n, \dots\}$  of *A* parties. *B* is not at risk, since she can condition her action on *A*’s choice. Although each *A* only participates in one negotiation, so she cannot develop a reputation, she does observe the previous outcomes of others clearing with *B*; hence, she can condition her behavior on what *B* has done in the past. The following strategy by each *A* party will support honest behavior provided the future is sufficiently valuable to *B*: “I will be honest, so long as you have never deceived a previous *A* person. Otherwise, I will not trust you.”

As before, we can introduce complications such as providing the *A* parties with only a noisy signal of *B*’s behavior. The result is the same as with two enduring parties: to the extent each *A* party can observe *B*’s past actions and so long as the future is sufficiently important to *B*, *B* will want to maintain a reputation for honesty. As before, we make the assumption that whether a party endures is a given. In reality, an enduring party might choose to leave a business. In this case, there would be an incentive for deception in the final transactions, provided that the non-enduring parties were in the dark about this termination decision. A case of this sort was mentioned earlier: the computer company offering warranties on its machines, even though it is secretly planning to go out of business.

3. Reputations in One-shot Negotiations. But what if neither party is likely to have a continued presence in a given negotiation market and the parties are likely to be negotiating together only a single time? This is the

case of the principals in many civil litigation cases. Can reputations be used to reduce the incentive for deception? The answer is clearly no, if we cannot create something to carry the reputation, but often it is possible to create a reputation bearer.

Metopians might do this by hiring an enduring agent to perform the negotiation. Lawyers in a litigation case might serve this purpose. Even if the plaintiff and defendant are antagonistic adversaries, their lawyers may have established reputations for the efficient and equitable resolution of disputes. The lawyers' use of deceptive tactics is limited to the extent such tactics would adversely affect their reputations. Similarly, when a firm hires an auditor to prepare a financial statement before a public stock offering, the firm is renting the reputation of the auditor to add credibility to the firm's statement to potential investors (Wilson, 1983). The firm cannot be trusted on its own, since deception would raise the proceeds from the offering. Hence, an auditor who maintains a valuable reputation for honest behavior is an essential ingredient of the transaction. In Metopia, we would expect to find a variety of reputational agents.

This strategy, however, is not always available. It may be difficult to motivate the agent to act in the principal's best interests. Divorce attorneys may be in an excellent position to settle rationally the dispute of an emotional and antagonistic couple, but if they are paid by the hour their financial incentive may be to magnify the conflict. Alternatives, such as a fixed-fee contract, may not be feasible, since it exposes the attorneys to adverse selection (only the most time consuming conflicts may be submitted to an attorney for a fixed fee) and threatens the couple with moral hazard (the attorneys may shirk on their responsibility to find an efficient and fair settlement in favor of a quick settlement).

An alternative to the use of reputational agents when the parties to a negotiation are not likely to interact again is suggested by Kreps (1990). Suppose the party, *A*, that puts the other, *B*, at risk can buy a name that indicates honest behavior because past holders of the name have been honest. After buying the name, *A* decides whether to act honestly, and then sells the name to another party. If the sale is delayed until *A*'s honesty can be determined, the sale price of the name should depend on *A*'s behavior. By acting honestly, *A* preserves the value of the name. Deceit would destroy the name's good reputation and hence its value. Viewing reputations as an asset that can be bought and sold, enables the parties to make deals that require trust, even if they are involved in only a single negotiation. Of course, there are limits to this technique. It requires that the reputational names be protected and treated as property. Its effectiveness depends on the price of the name and on the probability that any deception would be detected before the name is sold. If the payoff from deception is too high, relative to the cost and potential worth of the name, *A* will forfeit the investment in the name in favor of deception. It is important for *B*, the party at risk, to know how the name's value depends on *A*'s behavior.

#### *Summary of Factors Affecting Deception in Metopia*

Even in the self-centered world of Metopia, deception would be moderated by natural forces in a wide range of circumstances. To preserve fruitful transactions, Metopians will protect themselves (and their trading partners) from deception when they can do so in a cost-effective way. Since even the suspicion of deception can be harmful to potentially profitable negotiations, it is worthwhile for the negotiating parties to find means of reducing it.

Honesty, however, is not always the best policy by Metopian standards. Occasionally, Metopians will be able to gain from deceptive tactics. Based on the above analysis, we would predict that in Metopia, other things equal, deception is more likely to be a problem when the following conditions hold.

*Information asymmetry is great.* The greater the information disparity between the two parties, the more opportunity at least one of the parties has for profitable deception. Every negotiation involves some asymmetry. Each negotiator possesses some private information, such as information about her preferences, or about her intentions to keep future commitments.

*Verification is difficult.* Some questions, such as the physical condition of a simple, existing product, can be easily settled before the deal is consummated. Others, such as long-term maintenance costs for a new product, can only be confirmed afterwards. And some, such as a party's reservation price, are difficult to ever confirm. Deception is more likely with matters that are most difficult to verify, such as the other party's preferences, their commitment to future actions, and long-term performance claims about the good under negotiation. Because it makes verification to a third-party difficult, deception is also more likely to occur when claims are made verbally without independent witnesses.

*The intention to deceive is difficult to establish.* Deliberate deception is often hard to distinguish from a mistake or oversight. Deception is more likely when the deceiver has a plausible alternative explanation for her behavior. Deception about something one should clearly know is less likely than deception about matters for which one could innocently claim to be the victim of misinformation. Subtle forms of deception are more

likely to occur than explicit lying. The use of negotiating agents may also make it difficult to detect intentional deception. The principal can claim that the deception was the result of poor communication, or an unscrupulous negotiating agent who acted without authority. Finally, vague or sweeping claims that are open to alternative interpretations make it difficult to establish intentional deception. In such cases, a negotiator can more plausibly claim that she never meant to give a false impression.

*The parties have insufficient resources to adequately safeguard against deception.*<sup>22</sup> Depending on the expected gains from the negotiation and on the initial endowments of the negotiating parties, there will be limits on the resources available to protect the parties against deception. Warranties, collateral, hostages, and other insurance devices use up resources. They may be potentially useful, but not sensible in transactions promising small gains. In larger, more risky transactions, the negotiators may have too few assets to create bonding devices sufficient to eliminate incentive problems.

*Interaction between the parties is infrequent.* Deception is more likely in one-shot negotiations than in long-term relationships. The expectation of continued interaction provides negotiators with more time and a greater incentive to confirm the reliability of information provided or signaled by the other party. It also provides more opportunities for retaliation in future transactions.

*Ex post redress is too costly.* If deception is uncovered after the deal is done, there may be means of seeking redress, either individually or through third-parties. One could track down the offender and threaten harm, unless adequate compensation is provided. Alternatively, one could take the offender to court. The deceived party may prefer such an effort, even when the costs of it exceed the expected compensation, if the action has enough reputation value. Aggressive action in one case may dissuade future negotiating partners from attempting deception. Sometimes, however, the costs and risks of seeking redress are too high,<sup>23</sup> even recognizing the reputation value. In other cases, such redress is not feasible, because the deceived party has little leverage over the deceiver, the deceiver cannot easily be found, or the deception cannot be adequately demonstrated to a third-party (a court, or future negotiators).

*Reputation information is unavailable, unreliable, or very costly to communicate.* When it is difficult to convey information about the past performance of negotiators, we can expect more deception. We should find less deception in small, close-knit communities, or in dense social networks, than we do in large, loosely connected populations. Even in Metopia, there may be situations in which handshake deals are possible, without formal contracting. We should also find less deception when there is a relatively low cost system for collecting and transmitting reputation information, such as a Better Business Bureau.

*The circumstances are unusual in a way that limits inferences about future behavior.* Some instances of deception are unlikely to damage future negotiations, because they occur in distinctly different circumstances. The question is whether future negotiating partners would regard a particular act of deception as relevant to predicting behavior in negotiations with them. For instance, deception in a game setting, such as bluffing in poker, may not be thought to have any bearing on expectations of behavior outside of the game setting. Deception of an enemy or of an outsider, may not affect negotiations with a friend or an insider.

*One party has little to lose (or much to gain) from attempting deception.* The mechanisms discussed so far work only when each negotiator has expectations of a continuing economic life, places reasonably high value on future economic success, and has a reputation to protect. However, in some circumstances, a negotiator may not be concerned about the prospects of being caught at deception, provided she is not caught until after the deal is closed. The negotiator may have a reputation that is so bad that further deception would not hurt it. She may have a high discount rate, placing a low value on future transactions. She may be in desperate straits. Or, the payoff from this one negotiation may be sufficiently high.

These above conditions represent rough guidelines about when Metopians have greater incentives for profitable deception. Whether to attempt deception in a given situation requires a complex assessment of expected costs, benefits, and risks.

#### *Real World Differences*

We have offered some specific hypotheses about incentives for deception in Metopia. To what extent do our findings about Metopia extend to the world we know? Human nature is not so simple or uniform as that of the Metopians.<sup>24</sup>

*People are not as self-centered as Metopians.* They are capable of a wide range of sentiments and commitments not available to Metopians. Some of these sentiments work to promote honesty; others encourage more deception.

People often care about others. Most people have some benevolent motivations and ethical commitments. Individuals have sympathy for the pains of others and take pleasure in others' well-being. However, this care does not typically extend to all of humankind, but only to a referent group (Hirschliefer, 1982). The size and

nature of that group varies significantly from person to person. The care also varies in intensity, depending on such things as the closeness of the relationship with the other person. In addition to this passive care for others, people care about how they affect others (Arrow, 1974). They generally do not want to cause harm, and do want to cause pleasure or satisfaction. Individuals typically do not want to benefit from the misfortune of others, even when they have not caused the misfortune (Nagel, 1975).

Beyond concerns about the welfare of others, most have internalized rules of behavior so that they feel pangs of conscience, guilt, or shame when they resort to certain objectionable behaviors such as deception. They have preferences about how they act as well as preferences about the results of their actions. Many take pride in their sense of personal integrity. They take offense at any suggestion that they are not trustworthy. On a social level, people feel and express moral approbation and disapprobation about the behavior of others, even when the other's behavior is not a direct threat to them. They are willing to incur costs to shame, ostracize, and punish others who engage in questionable behavior.

On the other hand, people also have preferences that may encourage deception. Benevolence and moral commitments typically have limits. People are concerned about their own well-being and generally place more weight on their own welfare than on that of others. Furthermore, people tend to be competitive. Relative standing matters. People want to win, to do better than their peers. The harm they are willing to commit on their way to winning may be limited—each will draw the line somewhere—but many are willing to cause harm to have an advantage. For many people, moral commitments are contingent upon a belief that others share the same commitments. Many individuals, especially in competitive settings, are moral pragmatists, willing to do their part, but concerned not to be taken as a sucker or a fool. At the extreme, some people actually appear to take pleasure in harming other parties in a negotiation. People can carry grudges and vendettas beyond reason. They are capable of malevolence and spite. Some even take a particular pleasure in successful deception. The evidence for this is the large number of games where bluffing and deception play a role in the enjoyment of the game and in determining success. Some individuals carry the thrill of fooling others out of the game setting into other more serious negotiations.

People are not as smart as Metopians. Individuals in the real world vary more in their ability to make rational calculations. None reach the level of intelligence found in Metopians. Consequently, people are more likely to make mistakes in reasoning about the costs and benefits of deception. Some opportunities for self-interested deception will be missed as a result of such mistakes. Also, because of the common affliction of myopia, the bias toward clear short-term gains, some individuals will see opportunities for deception even when they would disappear with a longer view. Hume (1751) identified the risk of opportunism by frail humans. Of those who attempt to selectively use deception only when it appears to be in their self-interest he says, “while they purpose to cheat with moderation and secrecy, a tempting incident occurs, nature is frail, and they give into the snare; whence they can never extricate themselves, without total loss of reputation, and the forfeiture of all future trust and confidence with mankind.” Hume identifies a real risk, but exaggerates the repercussions of getting caught in a deception. As Bhidé and Stevenson (1990, p. 129) observe, “Even unreconstructed scoundrels are tolerated in our world as long as they have something else to offer.”

Because of the limits of human rationality and intelligence, judgments of trust may be made hastily without adequate supporting evidence. In some cases, individuals will not appreciate the powerful incentives for deception. As a result, individuals may be gullible and believe others when it would be more reasonable to discount their claims. This opens the door to more deception. However, sometimes people err in the other direction and exhibit more distrust than is rational. Bad experience in a negotiation can make people cynical about the trustworthiness of others. They may ignore the structural differences from one negotiation to the next, irrationally distrusting the other party regardless of the incentives. Such a person is likely to overinvest in protective measures.

What can we conclude from these differences? The main lessons can be summarized briefly. In the real world, mutual benevolence, moral commitment, and mutual trust are available as tools for promoting honesty in negotiations. However, there is so much variation in individual moral attitudes, characters, and abilities that it is hard to develop strategies for promoting honesty that are robust. People do not wear their characters on their sleeves. Negotiators often face significant uncertainty about the trustworthiness of the party on the other side of the table. The chances for honesty depend not only on the structural conditions that permit self-interested deception in Metopia, but also on the psychological forces in individuals and in the communities in which they live. A benevolent person supported by a community that reinforces that benevolence is less likely to engage in opportunistic deception than a Metopian would be. A more competitive person from a community of competitive persons is more likely to be deceptive. In either case, how the individual behaves may be a function of that individual's attitudes toward and expectations of the other party in the negotiation.

Despite the differences, we believe that the Metopian model presents a useful starting point for thinking about the problem of deception in real world negotiations. Self-interest plays an important role in the real

world. Reputation, verification, and contractual mechanisms are viable means of reducing the inefficiencies caused by deception and providing a basis for trust.

### *Promoting Honesty in Negotiation*

Given that deception is a regrettable feature of negotiations, both morally and practically, what can be done by ethically concerned people to promote more honesty? Before describing individual strategies, it is useful to review how existing institutional arrangements work to support honesty.

#### *Social and Institutional Support*

Those who think social engineering for ethics is unwise or unnecessary should reflect on the many institutions (public and private) that already exist with this end in mind. Many of the mechanisms that we noticed in Metopia are part of standard practice in the real world.<sup>25</sup> Individuals deciding on strategies for promoting honesty should be aware of the support mechanisms already in place to promote honesty and trust. This is not to say that further institutional improvement is impossible. Something may be learned by reflecting on the strengths and weaknesses of existing mechanisms. Entrepreneurial extensions and innovations (both in the public and private sectors) may be possible.

*Legal and Regulatory Protection.* The most obvious social support mechanism is government enforcement of norms. Not only do we have civil and criminal law, but we have in this country elaborate regulatory mechanisms. Regulators not only set rules, but also do the research that individual consumers could ill afford. Examples of legal and regulatory protections are numerous. On the federal level, they range from the effort of the Federal Trade Commission to control deceptive advertising, to the Food and Drug Administration to screen medications before they can be sold to the public, and the National Labor Relations Board to adjudicate disputes between business and organized labor. State governments, for instance, enact “lemon” laws to protect car buyers, and seller disclosure requirements to protect house buyers. One can debate the effectiveness and efficiency of any of these mechanisms, but they are clearly intended to help reduce deception in the marketplace.

In commercial negotiations, contract law is an important source of support for policing deception in negotiation. Negotiators should understand potential legal remedies and protections relevant to their negotiations. They are more extensive than many negotiators realize.<sup>26</sup> Unfortunately, the civil law is a rather blunt instrument for the enforcement of norms. For it to be effective, negotiators need to be aware of its provisions, the deceptive behavior needs to be verifiable in a court of law, and the parties must be willing to spend the resources (time and money) to seek remedies.

In addition to governmental regulation and adjudication, industries often have their own regulatory mechanisms. Sometimes it is in the interest of an industry to provide assurance of honorable dealings with its customers, suppliers, employees, and the communities in which it does business. For instance, in the securities industry, a form of arbitration is used to settle disputes between brokers and their clients. A negotiator should know whether any relevant industry regulations or dispute resolution procedures apply.

*Institutional Sources of Reputational Information.* In addition to formal adjudication mechanisms and regulatory agencies, negotiators may have access to formal sources of reputational information. Two prominent examples of this are better business bureaus and credit rating bureaus. Better business bureaus keep records of customer complaints and can provide this information to potential customers. Credit rating bureaus provide information on past payment performance of individuals. Negotiators also can gain access to legal and news databases that contain information on prior legal actions against the other party. These and other reputational databases may help negotiators decide with whom to do business. With information technology advancing, the costs of maintaining reputational databases should decline and their use should increase.

These institutionalized reputational databases are controversial. Questions have been raised about the completeness and accuracy of the information they dispense. Reputations may be unfairly ruined. Parties whose reputations are threatened may not be given a fair opportunity to rebut the allegations, or to make a case for extenuating circumstances. These databases may provide inaccurate, thin, or inappropriate information. The challenge for these sources is to maintain the integrity of their information. The challenge for users is to keep in mind that the information is imperfect.

*Independent Rating and Evaluation Services.* There have arisen several private organizations that test products, survey consumers, rate company performance, and provide other information to potential buyers. These organizations capitalize on the economies of scale associated with product and service evaluation. By

serving a large customer base, they can afford to engage in research that would be too costly for an individual.

One such organization is Consumers' Union, the publisher of *Consumer Reports* magazine. This organization evaluates products and services offered to consumers and makes the information available in its publications. Among other things, it provides information on dealer costs for new cars, price ranges for used cars, and information on the reliability and maintenance costs of various makes. Customers can use this information to make inferences about a car dealer's reservation price or to challenge any misleading assertions about the reliability of the car. Because Consumers' Union is independent from the manufacturers, it has credibility with buyers that manufacturers making quality claims about their own products would not have. Other examples of this sort of service are J.D. Power and Associates' customer satisfaction indexes, Lipper Analytical Services' mutual fund rating service, Underwriters' Laboratory's certification of electrical safety, Moody's and Standard and Poor's bond ratings, and A. M. Best's ratings of the financial strength of insurance companies. By providing an independent source of hard-to-get information, these organizations make it difficult for sellers to deceive about product quality, company financial strength, or the satisfaction of previous customers. Sometimes independent evaluators will even provide guarantees, as with the Good Housekeeping Seal of approval. Of course, these services work most effectively in large markets. For many commercial negotiations, sufficient economies of scale are not present to justify the creation of such an organization.

*Third-Party Professionals.* Negotiators often have access to professionals to assist in specific negotiations. They may be used to act as reputational agents, to assess important facts, or to arbitrate disputes. Industries that are organized in part for this role include lawyers, accountants, arbitrators, investment bankers, and engineers. The challenge in using third parties is in assessing their qualifications and aligning their incentives properly.

Professional associations often have mechanisms for improving information and incentives, thereby reducing the risk to the buyer of third-party services. For or instance, lawyers have strong norms to faithfully represent their clients' interests. These norms are supported by codes of ethics, which are enforced by the state's bar association. The hat also sets minimum quality standards.

*Standardized Contractual Mechanisms.* Norms are also established in certain industries to provide standard protections that go beyond legal requirements. Products and (increasingly) services often come with warranties. The use of collateral to secure certain types of loans against repayment risks is also a common institutionalized practice.

*Affiliations and Credentials.* It is also common in some industries for individual businesses to join together under a common name, or to purchase the rights to use a name for reputational purposes. Sears sells the use of its name to building contractors who install fencing, aluminum siding, and other home improvements. Consumers who trust Sears and who believe Sears stands behind the contractor's work may be more willing to trust a Sears affiliated contractor than an independent contractor with whom they will clear only once. In industries with many independent practitioners, industry associations can play a similar role.

They provide members with a certification of credibility. Examples include Chartered Life Underwriter, Certified Financial Planner, and Certified Public Accountant. These designations assist consumers in evaluating the level of professional expertise, and, perhaps, the ethics of practitioners. Even when a specific designation or certification process is not involved, affiliation with a reputable industry group, such as the Better Business Bureau or Chamber of Commerce, may provide some sense of trustworthiness.

Society has been remarkably creative in developing mechanisms to promote honesty and secure business transactions from the risks of deception. However, these institutional safeguards are not present, nor are they effective, in all arenas of negotiation. Sometimes individual negotiators have to develop strategies for promoting honesty and for protecting themselves from opportunism.

#### *Tactics and Strategies for Individual Negotiators*

What can be done by individuals who wish to promote honesty in their negotiation? We cannot recommend a single strategy that will work effectively in all negotiations. We can offer some strategic and tactical suggestions. They are directed to negotiators who see the value of honesty and mutual trust and are willing to make some investment in them. They are based on a rather extensive literature in the field of negotiation and conflict resolution,<sup>27</sup> as well as our experiences teaching and studying negotiation and business ethics.

Negotiators face two kinds of risks: trusting too much and trusting too little. The first risk is all too familiar. Most people can think of situations in which their trust proved to be unfounded. Painful memories provide powerful lessons. The second risk is not so apparent, in part, because the cost, which may take the form of a foregone opportunity, is not so vivid. However, this risk is just as real. As the movie actress's agent

in one of the Philip Marlowe detective stories comments, "One of these days . . . I'm going to make the mistake which a man in my business dreads above all other mistakes. I'm going to find myself doing business with a man I can trust and I'm going to be just too goddamn smart to trust him." (Chandler, 1955. p. 118; cited in Coleman, 1990). Coleman (1990, p. 100-101) points out that the mistake one should worry about most depends on the nature of the risks involved. A sensible strategy for dealing with the risks of deception is one that enhances trust in the negotiation and protects the participants from opportunistic exploitation. In specific situations, it is reasonable for one of these elements to be emphasized more than the other.

*Assessing the Situation.* No matter what strategy one pursues, the place to start is by doing one's homework. This seems like an obvious point, but it is surprising how many people cut this step short. Admittedly, it is not always cost-effective to do in-depth pre-negotiation research, but rarely should this step be skipped. There are many low-cost mechanisms for gathering information. For our purposes, pre-negotiation homework can be broken down into four steps.

1. Incentives for Deception. The questions here are based on what we learned about incentives in Metopia. The starting point in assessing vulnerabilities is to determine what sort of privileged information each side is likely to have. To what extent do you have to rely on them, and they on you, for important information? Are there natural incentives for either of you to exaggerate deliberately suppress or misrepresent any of this privileged information? Is there time pressure on either side? How important is a favorable outcome to each of the parties? This should be asked about principals and specific negotiating agents. It is generally thought to be a good thing if the other side in a negotiation is highly motivated to reach agreement. However other things being equal this creates a more powerful incentive for deception both to cover up a weak bargaining position and to persuade the other side to accept an agreement. It is also important to determine whether there are any factors to counterbalance these natural incentives. Are there easy means of verifying the information? How important is it for each of you to do business together in the future? How easy would it be for either of you to penalize or ruin the reputation of the other? These questions should be asked from your point of view and theirs. Do not expect them to fully appreciate the long-term and intangible benefits of honesty. Recognize that immediate payoffs can exert an inordinate amount of influence. Finally you should assess how bad it would be for either side if the other attempts deception.

2. Competence and Character of the Other Side. Whether you can trust the claims and signals from the other party is a function of your assessment of their character<sup>28</sup> and their competence. Competence in this context speaks to whether the other party would be a reliable source of information, even if they were honest. With regard to information about the item under negotiation, the party you are negotiating with may lack technical expertise, have access only to limited information or be susceptible to a natural bias. With regard to future actions the party may not have a realistic perception of her own (or her firm's) abilities to fulfill the promise. With regard to settlement issues if one is dealing with a new company representative for instance she may not know just how flexible she can be on price or terms. In cases of questionable competence, promoting honesty may not solve the problem of getting reliable information. Other steps may be required.

Evaluating the other party's character would not be necessary if we could simply observe when someone is attempting to deceive us. Though Ekman (1985) suggests that there are behavioral signs associated with lying, these are not so obvious and reliable to relieve us of the need to think about the character of the parties with whom we are dealing. Assessing character is usually done first by reference to one's own past dealings with the other party, and second by checking on the other party's reputation in the marketplace. One should check not only for instances of dishonesty per se but also for a general willingness to engage in objectionable behavior for selfish or competitive reasons. For the first you must ask how well do you know the other party? Are you really in a position to assess their character? If not, checking their reputation may be sensible. This can be done through any of the reputational sources of information mentioned in the previous section or, more directly, by interviewing their prior negotiating partners. The latter step may help it great deal at little cost. It is important to attempt to get an unbiased list. Instead of asking for references in general ask for a specific group that should be able to offer a fair and independent judgment, such as the landlord's last three tenants. In many cases, a candid assessment will be provided. However, in some situations, candor may be limited because of the fear of litigation or some other reason. For instance, one of the authors asked a group of mid-level executives whether they would provide an honest reference about a former employee who was dismissed for unethical conduct. The vast majority said they would not tell about the unethical conduct, unless the person requesting the information happened to be another manager within their company or a friend.

An inherent bias in evaluating someone's reputation is that reasons for distrusting someone are more convincing than reasons for trusting someone (Gambetta, 1988, pp. 233-5). Someone who lied in their last deal is not trustworthy, but is someone trustworthy because they appeared to be honest in their last deal? A further problem with reliance on reputational information is that it is often an inadequate gauge of character. One can find out about unsatisfactory performance, but usually not about extenuating circumstances. Past

performance failures may be the result of factors beyond the individual's control, or the person may have changed significantly since then. Someone who defaulted on a loan because of the financial drain of a serious illness may not be a bad risk for a new loan. Someone convicted of stealing something twenty years ago may be a very different person now. Though reputation information is and should be a valuable tool in assessing the trustworthiness and honesty of the other party, one should be careful not to place too much weight on it. Judgments about character based on this information must be tentative.

3. *Attitudes and Perspective of the Other Side.* The other party will enter the negotiation with a set of expectations and attitudes. Some of these will bear directly on their willingness to engage in deceptive behavior. One important matter concerns their attitude and beliefs about you. What is the other party likely to believe about you and your character? Will they identify with you? Will they trust you to be honest? Is there a history of animosity between the two of you, or between the other party and people like you? You also need to find out what they expect in the negotiation. This is especially crucial in cross-cultural negotiations. How do they expect information to be shared? How do they build trust with other negotiators? How adversarial or competitive are their negotiations? How are they likely to respond to different techniques of checking their veracity? Will your status as an "outsider" be a barrier to building trust?

4. *Critical Self-Reflection.* Finally, you must assess the biases and attitudes that you bring into the negotiation. You have a set of attitudes and presumptions, some of which may not be justified. Ask whether your attitudes are fair to the other side. Without critical reflection, there is a tendency toward cognitive inertia. This is a tendency to persist in certain prior beliefs by selecting and ignoring evidence. Both trust and distrust can persist beyond a reasonable point. Significant effort must be made to question your own beliefs and conclusions. Discussions with a third party whom you can trust to challenge your reasoning may be helpful.

The overall issue in all this "due diligence" is to establish a basis on which to craft an appropriate strategy. If the negotiating risks seem too high compared to the benefits, you may choose (if this is an option) not to negotiate with this particular party. On the other hand, if the risks are small, or the other side seems trustworthy and trusting, you may choose to simply negotiate in good faith. The costs of building trust or constructing protective mechanisms may not be justified. When the risks are moderate (or when they are high and you have no alternative but to negotiate), you must decide on a mix of building trust and protecting yourself from opportunistic, desperate, or defensive deception on the part of the other party. The mix will depend on the structure of the negotiation, time pressures, and whether you believe the other side is open to promoting honesty. If the other party is either highly opportunistic, or in desperate straits, attempting to build trust may be too risky.

*Building Mutual Trust.* In many cases, the incentive for deception in negotiation is defensive. It arises out of a suspicion that the other party is likely to be dishonest and out of a fear that the other party will unfairly exploit any weakness that is honestly revealed. This suspicion and fear may be overcome if a climate of mutual trust can be developed.

The level of trust with which a specific negotiation begins depends on the prior relationship of the parties, their individual reputations, their vulnerabilities to opportunism, and the established norms. We find some settings in which hand-shake deals are common, and others in which the distrust is SO high that a lengthy and complex contracting process is required.<sup>29</sup>

The general principle behind the trust building mechanisms is that one should demonstrate both trustworthiness and the ability to trust. The latter entails taking some moderate risks. As Adam Smith (1759, p. 531) observed, "We trust the [person] who seems willing to trust us." If we want to be trusted, we have to be able to show trust in return. In many cases, this trust will be reciprocated. It will promote honesty and reduce negotiating and contracting cost. In other cases, it will invite opportunistic exploitation. The process must be managed carefully. As long as the parties still have some divergent interests, it is unlikely that all deception, bluffing, or posturing can be eliminated.

The effort to build trust should match the opportunity. If the gains from trust are likely to be great and time and resources are available, a major investment in trust building may be justified. If not, trust-building activities may have to be constrained. The choice of techniques should also be tailored to the parties and the social context. Zucker (1986, p. 53) has identified three modes of trust production: "(1) process-based, where trust is tied to past or expected exchange such as in reputation or gift exchange; (2) characteristic-based, where trust is tied to a person, depending on characteristics such as family background or ethnicity; and (3) institutional-based, where trust is tied to formal societal structures depending on individual or firm-specific attributes, (e.g., certification as an accountant) or on intermediary mechanisms (e.g., use of escrow accounts)." Drawing on these modes, we outline some generic steps that might help business negotiators build trust.

1. Build Mutual Benevolence. One avenue available in the real world, but not in Metopia, is to build a personal or moral foundation for trust, by creating a sense of mutual benevolence.<sup>30</sup> The key here is to get each party to include the other in the reference group toward whom they feel good will, or a sense of moral commitment. It is easier to maintain distrust as long as the other party is seen as an adversary. One strategy for accomplishing this is to create more characteristic-based trust by highlighting any common religious, ethnic, family, or community ties shared by the parties. Another approach is to create opportunities for face-to-face meetings, either to discuss issues related to the negotiation, or simply to socialize. The use of preliminary meetings before the actual negotiation (or between negotiations) to discuss issues of mutual concern is becoming a more common element in labor-management relations. For instance, contracts between CBS and the IBEW now stipulate that the parties “shall meet at least once every three months, unless waived by mutual consent, to discuss subjects of mutual concern or interest...” The experimental gaming literature suggests that the possibility of communication between the parties typically enhances the probability of cooperation (Good, 1988). The use of pre-negotiation social contact and gift giving is common in Japanese (March, 1989) and Chinese negotiations. It serves to build trust and good will. If face-to-face meetings are to be arranged, the choice of site and arrangements can be crucial.<sup>31</sup> For trust building, it would seem wise to hold the meetings at a neutral location, or on the home turf of the most vulnerable party.

This strategy is not suitable to all situations. Sometimes direct contact between the principals may be risky. It may provoke more conflict and animosity, or one party may manipulate the other into unreasonable concessions. The prospect for these untoward outcomes is a function of the prior relationship, relative power, and attitudes of the parties. Each has to be willing and able to treat the other with respect.

2. Create Opportunities for Displaying Trust. Taking Adam Smith’s observation seriously, if you want to get the other side to trust you, you may want to show a willingness to trust them, within the bounds of prudence. If the negotiations will be on-going, or if the process can be broken into stages, this approach can be part of the early stages. Strategic trust building of this sort involves creating low (or moderate) risk opportunities, in the pre-contractual stage, to be trusting, and, thus, provide the other party with occasions to prove themselves trustworthy. This is a way of both testing their trustworthiness and sending a signal of respect. In creating these opportunities, it is important not to appear weak or naive. Mutual trust is not promoted by passively allowing yourself to be taken advantage of. The risk taken should be seen as reasonable, the other party’s performance needs to be at least partially observable before final contracting, and you should be prepared to demonstrate dissatisfaction if the trust is abused.<sup>32</sup>

As Hirschman (1984, p. 94) hypothesizes, trust seems to be the kind of social asset that flourishes with moderate use, but declines when not adequately practiced, or when practiced to excess. Accordingly, we are not suggesting a strategy of complete unilateral trust. In some settings this may be fine, but too often it would be disastrous. It invites exploitation. Nonetheless, a reasonable willingness to trust can be a powerful tool in building mutual trust.

There are two risks, even with modest trusting steps. One risk is that the trust will be abused. If there were no risk of this, it would not be trust. However, if the abuse is observed before further commitments are made, this provides extremely valuable information for going forward. It may be worth the cost. A more serious risk is that you are dealing with a clever opportunist, who plays along until the stakes get high and then exploits the trust. You have to rely on the due diligence process and your own judgment to help screen out extreme opportunists.

3. Demonstrate Trustworthiness. In addition to showing a willingness to trust, you should also show that you are trustworthy.<sup>33</sup> This is best done in the early stages of the negotiation. Again, the trustworthiness must be at least partially observable before final contracting. To show your trustworthiness, you may have to facilitate the other party’s verification. You may need to provide direct access to what would otherwise have been privileged information. Trustworthiness that will not be apparent until much later cannot help build mutual trust in the pre-contracting stage. One difficulty with this strategy is that you do not fully control the opportunities to demonstrate your trustworthiness. These opportunities will, in large part, be a function of the other party’s decisions to trust you. It is essential for trust-building that negotiators create and vigilantly watch for opportunities to show that they can be trusted. It is wise to keep even small promises, and be candid about matters that the other side may already know (from their due diligence) or could verify before the deal is complete. Anything short of this could undermine the trust built to that point. As Dasgupta (1988, p.62) points out, “although a reputation for honesty may be acquired slowly, it can generally be destroyed very quickly.”

Of course, there are risks in being fully trustworthy. In some cases, it is not possible to conceal your negotiating vulnerabilities without being deceptive. If you are under time pressure and are asked, “How soon do you need to close the deal on this building?”, it is hard to conceal your vulnerability without seeming

shifty and evasive. The question is not out of line if timing is an important matter for the other party. Being trustworthy may require you to be trusting.

A variation on the strategy of being trustworthy is to offer to stand behind your claims, by using some of the contractual devices we discussed in Metopia (warranties, collateral, etc.) to show that you are willing to protect the other party from the risk and uncertainty of relying on your word. In contrast to visible trustworthy behavior, this can be done with claims that cannot easily be verified before the other side makes a commitment. The point of doing this is not to set a precedent of always using contractual mechanisms to secure the trust. This would defeat the purpose of building trust. Rather, the purpose of such an offer is to signal good faith, in hopes that a sincere show of good faith on one important issue will alleviate the need for further contractual protection.

4. Place the Negotiation in a Longer-Term Context. When negotiating with someone for the first time, it may be tempting for both parties to think of the negotiation as a one-shot deal. We have seen the incentive problems this can create. When business people develop norms of constantly shopping for the best deal, with no long-term commitment to specific suppliers or customers, they invite this risk. It has been claimed that many of the recent problems on Wall Street result from a breakdown in investment bank and client relations. As investment banks get more aggressive and clients shop around for specialized services, it increases the incentives for drawing a client into a deal that will generate large fees for the bank today, but that might harm the client in the long run.<sup>34</sup> A wiser long-term strategy may be to demonstrate a willingness to be a loyal negotiating partner. By placing the negotiation in the context of being first among many, the incentive problem may be removed. Within an on-going relationship, the parties can invoke a number of strategies to encourage honest behavior. The fact that these strategies are available should provide some comfort.

Demonstrating loyalty to a relationship takes time. This is hard to do credibly in an initial negotiation. However, some contractual devices can promote this. For instance, making a follow-on service contract part of the deal may help. Alternatively, providing and asking for references can emphasize the importance of reputations and convince the other that you are interested in the long run.

5. Bring in Mutually Respected Intermediaries. A final possibility is to induce trust by involving a mutually trusted intermediary. This intermediary can serve as a conduit for trust and as a form of security. Though trust may not be perfectly transitive, finding an intermediary who can vouch for the reliability of each of the parties to the negotiation may provide some comfort. This comfort is strengthened when the third party is in a position to reward honest behavior, or punish dishonest behavior (Brams, 1990, pp. 29-61). This practice is common in cross-cultural negotiations when the party from country *X* hires a respected consultant or representative in country *Y* to facilitate negotiations with another party in country *Y*.

This is not the same as hiring reputational agents, such as lawyers to handle the negotiation. The use of lawyers, generally, does not build mutual trust, though it may reduce the incentives for certain forms of opportunistic behavior. It is not essential that the principals trust the other party's attorney. What is crucial in using the lawyers is that their reputations are at stake and that they can act to protect their clients from exploitation in that they have more experience in controlling opportunistic behavior. The differences in these two strategies is apparent from the fact that in some cultures, it is proper to work through a respected local agent, but outright offensive to propose negotiating through lawyers.

Trust building requires time and puts the negotiator at some risk. By using a mutually trusted intermediary, one may be able to shorten the time requirements, but costs and risks remain. Accordingly, trust building is only suitable when additional trust could have significant value, the stakes are high, the risks of trust building can be effectively managed, and the negotiation can be structured to provide sufficient time.

*Self-Protection.* Given the uncertainties associated with business negotiation, some element of self-protection and structuring of the incentives of the other party may be in order. *Caveat emptor* may not be a good legal rule, but it is reasonable advice for negotiators in many arm's length business transactions. In discussing Metopia, we identified several mechanisms that might be used to reduce the incentives for deception. Many of these will work just as effectively in the real world. However, when these mechanisms are proposed in the real world, the negotiator proposing them runs the risk of offending the other party: "Don't you trust me?" The offended party may respond irrationally by walking away or retaliating in some fashion. It may lead to an ever increasing spiral of mutual distrust.

Several techniques are available to make the proposals more palatable. Fortunately, many of the mechanisms serve multiple purposes. Many of them work to hedge against uncertainties that both parties face. They provide reliability. In some cases, they relieve the party with the information advantage of the pressure to decide what to disclose. The standard use of house inspectors in real estate transactions may be a relief to sellers who do not want to be liable for providing a comprehensive assessment of their house. To offset any undesirable implications, the individual proposing the use of protective mechanisms may need to offer the same sort of protection for the other side, or to pay for the added protection. Unless the other party has

behaved particularly badly, it would be wiser to project an attitude of reasonable prudence, rather than moral superiority.

The following tactics can be effective in protecting against opportunistic deception when opportunities for trust building are limited. Since many of these have been introduced earlier, we will keep our descriptions brief.

1. **Select Your Negotiating Partners Wisely.** The best protection is simply to avoid dealing with opportunists. Provide and ask for references. Consider their reputation, their relationship with you, and their incentives. When you decide to take a risk, do it with your eyes open.

2. **Verify What You Can.** Do your homework. Kick the tires. Tap into independent sources of information as available. Hire expert third-parties (e.g., inspectors, assessors, auditors, etc.) to assist. In many instances where there are incentive problems, this will be common practice. Request direct access to information that you need.

3. **Get Important Claims in Writing.** What you think the other party said and what they think they said (or claim they said) can be two different things, especially when a conflict arises. You should identify those areas in which you are relying most heavily on their word and ask for written clarification. If a written commitment is not feasible, see if you can get them to make their claims in front of an independent audience. Push for some precision. Vague claims and verbal assurances made in private make it difficult to confirm bad faith in court or to reputation channels. The claim should be clear and easily verifiable.

4. **Request Bonds and Warranties.** Warranties at least provide a written document to appeal to if difficulties arise later. They may be written so as to provide strong incentives for reliability. If the other party has enough resources, it may be wise to ask for collateral (or some other bond) to secure commitments and claims where their good faith will not be evident until after you have made irreversible investments. As noted in the Metopia discussion, these contractual mechanisms must be carefully crafted if they are to be effective and are not to induce more opportunistic behavior.

5. **Hire a Skilled Intermediary.** A skilled intermediary can serve many purposes. She can provide reputation value, negotiating expertise, legal or technical expertise, and a buffer from the other's manipulative tactics. Finding a suitable intermediary for self-protection is especially hard when you also are interested in building trust. As with any third party, the challenge is to find the right party and to provide them with the right incentives.

In general, we do not recommend that you go on the offensive. If you are vulnerable to exploitation and you have good reason to distrust the other party, it may be prudent to send deceptive signals to conceal your vulnerability. However, to engage in deception to level the playing field is a risky strategy. If you are discovered, it may lead to an escalation of questionable tactics and the loss of a good reputation. Unless the other party is widely recognized as a scoundrel who deserves to be dealt with in this way, future negotiating partners may be wary of dealing with you. Reputation channels may not be able to convey why your behavior was justified. In addition, deceit may affect your sense of integrity and cause stress. Deception must be used with caution, even when you believe it is morally justified.

Each of the steps we recommend for self-protection is costly. As with trust building, you need to weigh the costs against the benefits. Even when you have little reason to trust the other party, establishing protective mechanisms may be too costly. When the stakes are low, the wise course may be to accept the risk. Nonetheless, in many business negotiations, the stakes are sufficiently high and the level of trust sufficiently low, so that an investment in self-protection is worthwhile.

Many negotiations, particularly those at arms-length with strangers, require both trust building and self-protection. The former works to raise the moral climate, the latter to take the other party out of the path of temptation. The challenge is to strike the right balance. Too much self-protection can undermine the trust-building effort.<sup>35</sup> Care must be taken not to present inconsistent signals.

### *Summary and Conclusion*

Deception is a regrettable, but common element in negotiations. In this paper, we have provided a practical response to the problem of deception in negotiation. The foundation of the response is built on our analysis of a self-interested world, Metopia. This analysis reveals that deception is not monolithic. Different types of deception have different characteristics that need to be considered in promoting honesty. The analysis also illustrates the insidious nature of deception, showing how the mere possibility of deception can rob good faith claims of their credibility. Finally, our exploration of Metopia suggests many steps that can be taken, even with amoral individuals, to promote honesty.

Real people have a wider range of sentiments and are less rational than Metopians. Accordingly, we propose options for promoting honesty that reflect the differences between Metopia and the real world. They

are set within the context of social institutions, public and private, designed, at least in part, to promote honesty. The options draw heavily on a growing body of empirical and theoretical research on negotiation and conflict resolution.

Because of the diversity of negotiation contexts, it is not possible for us to offer a specific strategy that will be effective on all occasions. We hope that our presentation of options allows practitioners to craft strategies appropriate to their situations. These strategies cannot eliminate all deception in negotiation. It is not always wise to invest in building trust, or protecting oneself. Even when it is wise, strategies based on the options we have presented will not always achieve their objectives. Nonetheless, if we are to narrow the Machiavellian gap between the normative ideal of honesty and the practice of negotiation, we must encourage negotiators to identify and pursue opportunities for promoting trust and honesty. We must also encourage them to participate in and improve existing institutional support mechanisms. Some practitioners may even embark on institution building ventures, providing new and better support for doing the right thing. The fight to extend the moral frontier into remaining pockets of Hobbesian behavior (Dees and Cramton, 1991) is a difficult one. It requires creativity and prudent risk taking.

*University of Maryland and Harvard Business School*

### Notes

\*We are grateful to Howard d Stevenson and Tom Piper for comments, and to the Harvard Business School, the National Science Foundation and the Hoover Institution for support.

<sup>1</sup> For a description of a variety of deceptive practices in everyday business, see Blumberg (1989).

<sup>2</sup> For more argument on this point, see Dees and Cramton (1992).

<sup>3</sup> We invoke a narrow notion of self-interest specifically to avoid two dangers inherent in broader notions. One danger is reflected in the meaningless conception of self-interest characterized by revealed preference theory, according to which even the most blatant self-sacrificial behavior is by definition self-interest. Sen (1977) exposes the weaknesses inherent in this definition. The other danger is that posed by some philosophers (see Kavka, 1984) who wish to broaden the notion of self-interest in a specific way, so as to guarantee that ethical behavior is self-interested. Ethical behavior becomes its own reward. Both of these views trivialize real incentive problems.

<sup>4</sup> For instance, an example of academic research in this vein is presented by Baiman and Lewis (1987), who conducted an experiment in which they found that though subjects exhibited some resistance to lying, modest monetary incentives were sufficient to overcome this resistance in a large number of cases.

<sup>5</sup> This mutual trust perspective on morality in practice is developed further in Dees and Cramton (1991).

<sup>6</sup> Though our definition is quite inroad, it excludes unintended deception, even where that deception could be foreseen and prevented. Such deception raises interesting issues, but to discuss them would be a diversion from our main objective. For detailed treatments of some definitional complexities, see Chisholm and Feehan (1977) and Fried (1978, Ch. 3).

<sup>7</sup> Some would suggest that honesty requires the disclosure of all relevant information, even when withholding that information would not qualify as deception on our account. We prefer to distinguish between honesty, i.e., the absence of deliberate deception, and candor, i.e., complete openness. For simplicity of analysis, we choose to focus on the former.

<sup>8</sup> This may seem problematic, because the standard assumptions of game theory imply that deception is never successful. Game theory assumes that the agents are intelligent and rational. As a result, agents recognize when deception is in another's self-interest, and are not misled. By not allowing gullible negotiators, we understate the incentives to deceive. Nonetheless, game theory provides a rigorous and consistent framework for thinking about incentive problems.

<sup>9</sup> For simplicity, we speak of one party having information that could be concealed, misrepresented, or truthfully shared. Technically, however, deception can occur even when the deceiver has no private information. It is enough that the other party to the negotiation believe that the first party has valuable private information.

<sup>10</sup> This latter strategy is effective on issues where one party expects a conflict of interest when none exists. In a study of experienced and naive negotiators, Thompson (1990, p. 88) found that successful, experienced bargainers disguised their compatible interests to feign "making a concession for the purpose of gaining on another issue."

<sup>11</sup> This is a rough statement of a theorem due to Myerson and Satterthwaite (1983). Cramton, Gibbons, and Klemperer (1987) show how the theorem depends on the distribution of the ownership rights when many parties share ownership. For an analysis of the inefficiencies caused by private information in dynamic bargaining models see, for example, Cramton (1992). Kennan and Wilson (1993) provide a survey of the literature on bargaining with private information.

<sup>12</sup> For now, we set aside the problem of contracting with these third-parties in Metopia. In order to assure the reliability of a third-party verifier, Metopian negotiators would have to use the same mechanisms that they use for promoting honesty in their primary negotiations.

<sup>13</sup> Under the broad heading of warranties we are including any promise to make an adjustment to the terms of exchange (provide a full or partial refund, repair or replace a product, etc.) based on what happens after the deal is consummated. This includes warranties against defects, performance guarantees, guarantees of satisfaction, price guarantees, and cancellation or refund policies.

<sup>14</sup> For a discussion of the value of service guarantees see Heskett, Sasser, and Hart (1990).

<sup>15</sup> It should be noted that price guarantees can have the effect of reducing price competition rather than assuring low prices.

<sup>16</sup> See Kronman (1985) for a discussion of the limitations of these devices in the absence of third-party enforcement. Though we allow a role for third-parties, the basic structure of his arguments still applies.

<sup>17</sup> We do not mean to suggest that warranties and bonds only serve to reduce incentives for deception. Even with universal due diligence and good faith, some uncertainties will remain in most negotiating contexts. These devices can be used to provide for a more efficient allocation of the associated risk.

<sup>18</sup> See Fudenberg (1992) and Pearce (1992) for surveys of reputational models in game theory.

<sup>19</sup> Alternatively,  $p$  could denote the discount factor in an infinitely repeated game or more generally the product of the discount factor and the continuation probability. In all cases, the analysis is the same.

<sup>20</sup> More forgiving punishments, such as tit-for-tat (see Axelrod, 1984), work as well. Indeed, so long as the continuation probability is more than 50%, assuming detection is certain, tit-for-tat sustains honest behavior, since  $2 + 2p \geq 3 + 0p$  for all  $p > 1/2$ . Dixit and Nalebuff (1991, pp. 113-5) suggest an even more forgiving strategy that takes into account the good will that might build up over time. In gaming experiments, Deutsch (1973, Ch. 12) found that a defensive, but non-punitive strategy could be quite effective in inducing cooperation.

<sup>21</sup> See Porter (1983) for a detailed analysis of this strategy or Abreu, Pearce, Stacchetti (1986) for an analysis of the optimal collusive strategy.

<sup>22</sup> For a more general discussion of limited transaction resources, in the context of contract law, see Maser and Coleman (1989).

<sup>23</sup> See Maser and Coleman (1989), for a discussion of the costs and risks of third-party intervention.

<sup>24</sup> Several of the differences we discuss are in Etzioni (1988).

<sup>25</sup> We concentrate here on secular mechanisms relevant to all in our pluralistic society. However, we would be remiss if we failed to note the importance of religion in inspiring and reinforcing the moral conduct of many individuals. Religion often relies not only on inspiration and moral exhortation, but also on powerful incentive systems, including monitoring of behavior by an all-knowing third party. For a discussion of the importance of moral retribution in religion, see Green (1988), especially pp. 12-16.

<sup>26</sup> See Shell (1991a and 1991b) and Farnsworth (1987) for discussions of the extent to which contract law applies to opportunism and fair dealing in the pre-contractual stages of negotiation.

<sup>27</sup> Many of the suggestions we make appear in a number of sources. See Deutsch (1973), Fisher and Brown (1988), Fisher and Ury (1981), Lax and Sebenius (1986), Lewicki and Litterer (1985), Raiffa (1982), and Rubin and Brown (1975).

<sup>28</sup> Fisher and Brown (1988) play down the importance of character, suggesting that reliability is largely a function of other things. We acknowledge other influences, but believe that perceptions of character are central to assessing the likelihood of honesty.

<sup>29</sup> The practical difficulties of eliminating deception are seen in the distrust often present in labor negotiations. For example, according to the *New York Times* (28 October 1990, p. B1), "At the core of the stalled New York City municipal labor talks is the union leaders' growing distrust of the claims being made about the city's financial plight." This distrust persists despite the fact that the setting allows for reputations (labor and management deal with each other on a regular basis), contractual mechanisms (wage rates could be tied to financial performance) and verification (management can open its books).

<sup>30</sup> Kronman (1985) suggests a highly specialized version of this called “union” in which the interests of the two parties are somehow united. He cites close family bonds as an example. Our recommendation is less extreme.

<sup>31</sup> Rubin and Brown (1975, pp. 82-91) point out how important the site and arrangements at the site are to control and dominance.

<sup>32</sup> This parallels Lindsold's (1978) conclusion, in evaluating a proposal for tension reduction in a conflict situation, that one must be “both conciliatory and resistant to exploitation” (p. 788).

<sup>33</sup> This is the linchpin of the Fisher and Brown (1988) plan for managing reliability and trust in a relationship, see especially their chapter 7.

<sup>34</sup> This points to an interesting tension that we will not discuss in this paper between encouraging healthy competition by being willing to move your business from one firm to another, and losing the value to be gained in long-term relationships.

<sup>35</sup> Ring and Van de Ven (1989) found that, in attempts to build relationships to pursue innovations, too much attention to formal protections of the individual parties could undermine trust created in the informal information sharing processes.

## Bibliography

- Abreu, Dilip, David Pearce and Ennio Stacchetti: 1986, "Optimal Cartel Equilibria with Imperfect Monitoring," *Journal of Economic Theory* 39, 251-269.
- Akerlof, George A.: 1970, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism." *Quarterly Journal of Economics* 84, 488-500.
- Arrow, Kenneth J.: 1974, "Gifts and Exchanges." *Philosophy and Public Affairs* 1, 343-362.
- Axelrod, Robert: 1984, *The Evolution of Cooperation* (Basic Books, New York).
- Baiman, Stanley and Barry Lewis: 1989, "An Experiment Testing the Behavioral Equivalence of Strategically Equivalent Employment Contracts." *Journal of Accounting Research* 27, 1-20.
- Bhide, Amar and Howard H. Stevenson: 1990, "Why Be Honest if Honesty Doesn't Pay," *Harvard Business Review*. September-October, 121-129.
- Blumberg, Paul: 1989, *The Predatory Society: Deception in the American Marketplace* (Oxford University Press, Oxford).
- Boatright, John R. 1992. "Morality in Practice: Dees, Cramton, and Brer Rabbit on a Problem of Applied Ethics," *Business Ethics Quarterly*. 2, 63-73.
- Brams, Steven J.: 1990, *Negotiation Games: Applying Game Theory to Bargaining and Arbitration* (Foundation Press, New York).
- Carr, Albert Z.: 1968, "Is Business Bluffing Ethical?" *Harvard Business Review*. January-February, 143-159.
- Chandler, R.: 1955, *The Little Sister* (Penguin Books, Harmondsworth).
- Chisholm, Roderick, and Thomas D. Feehan: 1977, "The Intent to Deceive," *Journal of Philosophy* 74, 143-159.
- Coleman, James S.: 1990, *Foundations of Social Theory* (Harvard University Press, Cambridge).
- Cramton, Peter C.: 1992, "Strategic Delay in Bargaining with Two-Sided Uncertainty," *Review of Economic Studies*, 59, 205-225.
- Cramton, Peter, Robert Gibbons, and Paul Klemperer: 1987, "Dissolving a Partnership Efficiently," *Econometrica* 55, 615-632.
- Dasgupta, Partha: 1988, "Trust as a Commodity." In Diego Gambetta (ed.), *Trust: Making and Breaking Cooperative Relations* (Basil Blackwell Ltd., Oxford).
- Dees, J. Gregory, and Peter C. Cramton: 1991, "Shrewd Bargaining on the Moral Frontier: Toward a Theory of Morality in Practice," *Business Ethics Quarterly* 1, 135-167.
- Deutsch, Morton: 1973, *The Resolution of Conflict: Constructive and Destructive Processes* (Yale University Press, New Haven).
- Dixit, Avinash K. and Barry I. Nalebuff: 1991, *Thinking Strategically: The Competitive Edge in Business, Politics, and Everyday Life* (W.W. Norton and Company, New York).
- Ekman, Paul: 1985, *Telling Lies* (W. W. Norton and Company, New York).
- Etzioni, Amitai: 1988, *The Moral Dimension: Toward a New Economics* (The Free Press, New York).
- Farnsworth, E. Allan: 1987, "Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations." *Columbia Law Review* 87, 218-293.
- Fisher, Roger and Scott Brown: 1988, *Getting Together: Building a Relationship that Gets to Yes* (Houghton Mifflin Company, Boston).
- Fisher, Roger and William Ury: 1981, *Getting to Yes: Negotiating Agreement Without Giving In* (Houghton Mifflin Company, Boston).
- Fried, Charles: 1978, *E Right and Wrong* (Harvard University Press. ( Cambridge).
- Friedman, James W.: 1971., "A Noncooperative Equilibrium for Supergames," *Review of Economic Studies* 38, 1-12.
- Fudenberg, Drew: 1992, "Explaining Cooperation and Commitment in Repeated Games." In J. J. Laffont (ed.), *Advances in Economic Theory: Sixth World Congress* (Cambridge University Press, Cambridge).
- Gambetta, Diego: 1988, "Can We Trust Trust?" In Diego Gambetta (ed.), *Trust: Making and Breaking Cooperative Relations* (Basil Blackwell Ltd. Oxford).
- Good, David: 1988, "Individuals, Interpersonal Relations, and Trust." In Diego Gambetta (ed.), *Trust: Making and Breaking Cooperative Relations* (Basil Blackwell Ltd., Oxford).
- Green, Ronald M.: 1988, *Religion and Moral Reason. A New Method for Comparative Study* (Oxford University Press, Oxford).
- Heskett, James L., W. Earl Sasser, Jr., and Christopher W.L. Hart: 1990, *Service Breakthroughs: Changing the Rules of the Game* (The Free Press, New York).
- Hirschleifer, Jack: 1982, "Evolutionary Models in Economics and Law: Cooperation versus Conflict Strategies." In P. H. Rubin and R. O. Zerbe, Jr. eds., *Research in Law and Economics* 4, 1-60, (JAI Press, Greenwich).

- Hirschman, Albert O.: 1984, "Against Parsimony: Three Easy Ways of Complicating Some Categories of Economic Discourse." *American Economic Review Proceedings* 74, 88-96.
- Holmstrom, Bengt: 1979, "Moral Hazard and Observability," *Bell Journal of Economics* 10, 74-91.
- Hume, David. 1751. *An Enquiry concerning the Principles of Morals*. References are to the 1975 edition (Clarendon Press, Oxford).
- Kavka, Gregory S.: 1984, "The Reconciliation Project." In D. Copp and D. Zimmerman (eds.), *Morality, Reason, and Truth* (Rowman and Allanheld, Totowa).
- Kennan, John, and Robert Wilson: 1993, "Bargaining with Private Information," *Journal of Economic Literature*, 31, 45-104.
- Kreps, David M.: 1990, "Corporate Culture and Economic Theory." In James Alt and Kenneth Shepsle (ed.), *Perspectives on Positive Political Economy* (Cambridge University Press, Cambridge) 90-143.
- Kronman, Anthony T.: 1985, "Contract Law and the State of Nature," *Journal of Law, Economics, and Organization* 1, 5-32.
- Lax, David A. and Sebenius, James K.: 1986, *The Manager as Negotiator: Bargaining for Cooperation and Competitive Gain* (The Free Press, New York).
- Lewicki, Roy J. and Joseph A. Litterer: 1985, *Negotiation* (Richard D. Irwin, Homewood).
- Lindskold, Svenn: 1978, "Trust Development, the GRIT Proposal, and the Effects of Conciliatory Acts on Conflict and Cooperation." *Psychological Bulletin* 85, 772-793.
- March, Robert M.: 1989, *The Japanese Negotiator: Subtlety and Strategy Beyond Western Logic* (Kodansha International, Tokyo).
- Maser, Steven M. and Coleman, Jules L.: 1989, "A Bargaining Theory Approach to Default Provisions and Disclosure Rules in Contract Law," *Harvard Journal of Law and Public Policy*, 12, 637-709.
- Myerson, Roger B. and Mark A. Satterthwaite: 1983, "Efficient Mechanisms for Bilateral Trading," *Journal of Economic Theory* 28, 265-281.
- Nagel, Thomas: 1975, "Comment." In E. S. Phelps (cd.), *Altruism, Morality and Economic Theory* (Russell Sage Foundation, New York).
- Pearce, David: 1992, "Repeated Games: Cooperation and Rationality." In J. J. Laffont (cd.), *Advances in Economic Theory: Sixth World Congress* (Cambridge University Press, Cambridge).
- Porter, Robert H.: 1983, "Optimal Cartel Trigger Price Strategies." *Journal of Economic Theory* 29, 313-338.
- Raiffa, Howard: 1982, *The Art and Science of Negotiation: How to Resolve Conflicts and Get the Rest Out of Bargaining* (Harvard University Press, Cambridge).
- Ring, Peter Smith and Andrew Van de Ven: 1989, "Formal and Informal Dimensions of Transactions." In Andrew H. Van de Ven, Harold L. Angle, and Marshall Scott Poole (ed.), *Research on the Management of Innovation* (Ballinger Publishing Company, New York).
- Rubin, Jeffrey Z. and Bert R. Brown: 1975, *The Social Psychology of Bargaining and Negotiation* (Academic Press, New York).
- Sen, Amartya: 1977, "Rational Fools: A Critique of the Behavioural Foundations of Economic Theory," *Philosophy and Public Affairs* 6, 317-344.
- Shell, G. Richard: 1991 a, "When Is It Legal to Lie in Negotiations?" *Sloan Management Review* Spring: 93-101.
- Shell G. Richard: 1991b, "Opportunism and Trust in the Negotiation of Commercial Contracts: Toward a New Cause of Action." *Vanderbilt Law Review* 44, 221-282.
- Smith, Adam. 1759. *The Theory of Moral Sentiments*. Reprinted in 1976 (Liberty Classics, Indianapolis).
- Sobel, Joel: 1985, "A Theory of Credibility," *Review of Economic Studies*, 52, 557-574.
- Thompson, Leigh: 1990, "An Examination of Naive and Experienced Negotiators," *Journal of Personality and Social Psychology* 59, 82-90.
- White, James J.: 1980, "Machiavelli and the Bar: Ethical Limitations on Lying in Negotiation," *American Bar Foundation Research Journal* 1980, 926-934.
- Wilson, Robert: 1983, "Auditing: Perspectives from Multiperson Decision Theory," *Accounting Review* 58, 305-318.
- Zucker, Lynne G.: 1986, "The Production of Trust: Institutional Sources of Economic Structure." *Research in Organizational Behavior* 8, 53-111.