Ex Post (In) Efficient Negotiation and Breakdown of Trade

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Abstract

Using a novel audit methodology, we show that reputation concerns and norms against price gouging can lead to breakdown in ex post efficient trade. Sellers in a market in India do not use their increased bargaining power to charge higher prices when customers have a shock, but, rather, forgo the order. However, when customers offer a higher price, sellers are significantly more likely to accept the order. When reputation costs are lower (out of state customers), sellers are more willing to initiate renegotiation. These results suggest that there are first order distortions to ex post efficient renegotiation.

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1. Introduction

One of the central building blocks of incomplete contracting theories is the assumption that parties to a contract will engage in ex post efficient renegotiation in case of shocks to the contracting parties (Grossman and Hart (1986), Hart and Moore (1988)). As long as the valuation of a product is higher for the buyer than the seller, mutually beneficial trade should occur. The final price will be determined by the allocation of bargaining power and outside valuations between the buyer and seller. However, several recent theories have raised doubts on whether it is a reasonable assumption that ex post renegotiation will always reach efficient outcomes, see for example, Williamson (1985) and Hart and Moore (2008). For example, buyers might not agree to changes in ex-ante agreed upon prices if they feel unfairly treated or "aggrieved", even if this makes them worse off ex post. Similarly, sellers in a market might not feel at liberty to suggest a price increase if they fear that this will harm their reputation or violate norms against price gouging. These forces could lead to deviations from ex post efficient renegotiation or even breakdown of trade. Such distortions could be especially important in environments where legal enforcement is weak or settling of legal claims is prohibitively expensive, as in developing countries or transactions between small businesses in developed economies.

Despite the longstanding debate in the theoretical literature, there is little empirical evidence on the willingness of contracting parties to engage in renegotiation and the form of these interactions. In this paper, we set up a field experiment in India to examine whether contracting parties exploit changes in their bargaining power or, alternatively, whether there are constraints in their willingness or ability to renegotiate. And importantly, what are the frictions in renegotiation that lead to breakdown of trade? For that purpose, we conduct a field audit with tailoring stores in Chennai, a city in Southern India. We sent trained auditors acting as customers

to place tailoring orders to have a garment stitched. Each visit varies across three dimensions: (1) the bargaining power of the customer, (2) the direction of who initiates the renegotiation and (3) the level of reputational concerns for the tailor. We vary the bargaining power of the tailor by introducing an urgency for the customer. When placing the tailoring order, auditors either convey upfront that they have an urgency and need the garment stitched within a day (upfront urgency). Alternatively, auditors place a regular order first, but then return to the store the same day and ask for expedited stitching of the garment within one day due to an unforeseen emergency (in-between urgency)[1]. Thus, the main difference between the two treatments is that the bargaining power of the tailor is higher in the in-between urgency since he or she holds the cloth for the order and would not have to return it. In this second treatment, tailors should be able to extract a larger fraction of the rents from the transaction[2]. We are careful to isolate a shock to bargaining power and not to the valuation of the buyer, since in both treatment (upfront urgency) and control (in-between urgency), it is clear to the tailor that the value from getting the work done urgently is very high to the customer.

To rule out that tailors' unwillingness to renegotiate is driven by constraints, such as capacity constraints or extremely high disutility from doing any overtime work, we add an additional treatment. In case tailors refuse the urgent order, auditors offer the tailor extra money (twice the original price) for getting the work done urgently. If tailors are truly capacity constrained then additional money should not make a difference in the acceptance of an urgent order. However, if we see asymmetric effects based on who initiates the renegotiation, it would suggest that tailors do not want to be seen as price gouging by demanding a higher price.

[1] The normal stitching time is one week while the urgent request is to get the order done within one day.

[2] Also in the in-between urgency, tailors have already spent significant time taking the measurements of the customer. Therefore, the costs of foregoing the order are higher in this case as compared to the upfront urgency. The increase in the costs and the additional bargaining power should therefore make it more likely for tailors to renegotiate the price in the in-between urgency as against the upfront urgency. .

We also test whether tailors might be reluctant to initiate a price renegotiation due to reputation concerns or violation of a social norm, if customers perceive an attempt to renegotiate prices ex post as opportunistic behavior. We include a further treatment arm where we send auditors who are from a different part of India and who clearly state that they are only in town for a one time event (out of state). This should reduce the reputational effects of renegotiation for the tailor. Note the reputation concerns themselves must rely on the idea that price gouging is a violation of an underlying norm of desirable behavior.

We find that tailors on average demand the same price for in-between urgency as compared to the upfront urgency. When faced with the in-between urgency, tailors do not initiate a renegotiation but either agree to fill the urgent order with no price increases (in 46% of the cases) or tell the auditor that they cannot complete the order and offer to give the cloth back (in 50% of the cases). This is surprising since, in our set up, tailors have more bargaining power in the in-between urgency case, but they do not use it to renegotiate prices, even if it leads to the breakdown of trade.[3]

In contrast, when the auditor offers the tailor a higher price (our extra money treatment), a significantly larger fraction of tailors are willing to fill the urgent order. Of the 54% of tailors that refused initially to fill the urgent order, 25% are willing to do the job if the auditor initiates the negotiation. Surprisingly, the impact of the auditor offering extra money is equally high for upfront urgencies as for in-between urgencies. It confirms that tailors are so concerned about not being seen as unfairly taking advantage of customers that even in the upfront case they only accept more money if the customers suggests it. Capacity constraints cannot explain the reluctance of tailors to renegotiate but instead it appears that tailors do not want to be seen as

[3] The results are not driven by any differences in the acceptance rate for the upfront urgency as compared to the in-between urgency.

price gouging. Indeed we find that even in the case where tailors agree to do the work for additional pay, they do not take the entire 100% price increase that is offered but on average suggest that they need only 40% more.

Finally, we find that for out of state auditors, tailors are more likely to initiate a renegotiation in the in-between urgency case compared to local auditors. Interestingly, when offered additional money in the in-between urgency case, tailors ask out of state auditors to pay a higher upcharge compared to local auditors. However, the magnitudes are small, suggesting that even for out of state customers where reputation concerns are small, tailors are reluctant to engage in ex post price gouging.

We argue that the unwillingness of tailors to renegotiate constitutes a breakdown in ex post *efficient* trade. Customers would be better off if the tailor is willing to do the urgent job against an upcharge, rather than returning the cloth to them and trying to find a different tailor.[4] Our results suggest that reputation concerns and, in particular, norms against price gouging prevent tailors from initiating a renegotiation and, as a result, are willing to allow breakdown of ex post efficient trade. Note that even though we find ex post inefficiencies in renegotiation, the contract structure that we observe could be ex ante efficient if contracting parties anticipate the breakdown.

A remaining question in interpreting our results is whether, in equilibrium, the reluctance of tailors to renegotiate leads to a distortion in the first best outcome. If negotiating parties in the market knew that there was a signaling equilibrium where customers with a real urgency have to offer more money, there might not be a distortion from the first best outcome: Tailors might

[4] We calculated that the cost of transportation and the loss in time is much higher than the upcharge tailors on average are willing to accept in order to fill the urgent order (discussed later).

never start a renegotiation, since customers will know to suggest a higher price when they need an urgent delivery.

To examine whether this type of signaling behavior plays a role, we conduct a test of the supply side of the market. We partnered with a couple of tailors who assisted us in auditing actual customer visits. In the first treatment, when a new customer enters with an urgent request, the tailor does not initiate the renegotiation but refuses to take on the urgency. We find that customers never offer a higher price out of their own volition, which suggests that customer-initiated renegotiation does not seem to be the norm. We then test the reverse direction: when a new customer visits the tailoring shop and expresses urgency, the tailor initially refuses the urgent request, but then asks for an extra charge to do the urgent delivery (approximately 10% increase over the standard stitching charge). Again, we see that when the tailor asks for extra money, customers do not push back and willingly accept to pay extra to get urgent delivery. These results rule out that there is a signaling equilibrium in this market where customers always offer extra money if they have a truly urgent order.

The rest of the paper is structured as follows. Section 2 discusses the empirical set-up. Section 3 describes the methodology of randomization. Section 4 describes the data. Section 5 presents the empirical results. Section 6 concludes.

1.2 Related Literature

Our paper contributes to several strands of the literature on incomplete contracting (Hart and Moore, 1988; Tirole, 1986; Aghion et al., 1994; Williamson, 1985). By examining the renegotiation process and outcomes, we highlight the frictions that arise during renegotiation. Our paper is the first field experiment to show that there is a breakdown in ex post trade due to

inefficiencies in the renegotiation process. The results suggest that reputational concerns and norms against price gouging could lead to reluctance by market participants to initiate renegotiations, which in turn results in ex post inefficiencies and breakdown of trade. Our analysis is also consistent with several recent theories that highlight the ex post inefficiencies in renegotiation (Fehr and Schmidt, 1999; Hart and Moore, 2008; Hart 2009; Herweg and Schmidt, 2012). In settings where contract enforcement is weak, i.e., where it is difficult to enforce laws which require that renegotiation is done in "good faith", social norms evolve to mirror the law.[5]

In addition, we contribute to the literature on the role of social capital in financial development (Guiso et al., 2004; Guiso et al., 2006; Putnam, 1983). These papers emphasize the importance of social capital in sustaining trade and contracts in settings where legal enforcements of contracts are weak. In this paper, we highlight that while social capital helps prevent opportunism by contracting parties, it can also have a cost by creating inefficiencies in renegotiation. This discussion is related to the literature on the role of reputation and norms for contracting (Crocker and Reynolds, 1993; Banerjee and Duflo, 2000; McMillan and Woodruff, 1999). Similarly, papers by Klein and Leffler (1981); Kreps et al. (1982); Tadelis (1999 and 2002); or Jin and Leslie (2009) have highlighted the role of reputational incentives in overcoming information frictions. While these papers focus on the benefits of reputation in solving ex ante contracting frictions, our results highlight some of the ex post inefficiencies that could arise due to reputational concerns.

Lastly, we are related to a growing experimental literature that studies contracting and bargaining in laboratory settings (see for example Fehr, Hart and Zehnder, 2009 and 2011; Hoppe and Schmitz, 2011; Bartling and Schmidt, 2013). In particular Bartling and Schmidt (2013) are close in spirit to our paper. They find that in a laboratory setting, many sellers are likely to deliver the

[5] See Hart and Moore (2008) for a detailed discussion.

good without any price increase despite an increase in the buyer's valuation for the good. In comparison, in our study, roughly 50% of the tailors make the changes without an upcharge, but in 50% of the cases, they give back the cloth and refuse to deliver the product at the specified urgent date. We believe that the difference in the results is primarily driven by two factors: (a) that their experiment does not allow for breakdown in trade, and (b) subjects in the lab find themselves in anonymous, one-shot interactions that do not emphasize the reputation channel.

2. Description of Experimental Set-Up

The field experiment was conducted in Chennai, a city with over 4.5 million inhabitants that is the largest in the South Indian state of Tamil Nadu. To conduct the study, we hire auditors who visit tailoring shops and place orders under different scenarios. We chose the tailoring industry to conduct our study for a number of reasons. First, there are a large number of similar sized establishments located in the same region, which minimizes the impact of location specific shocks on our results. Competitive pressure within the industry has also forced prices to converge to a similar range for standard stitched items, facilitating comparison of the deals offered. Finally, we wanted an industry where first time customers could place stitching orders without a prior history of interactions.

2.1. First Experiment: Field Audits

We hired auditors who were familiar with the process of bargaining and who also had prior experience placing stitching orders in tailoring shops. We verified that the auditors were not affiliated with the tailoring industry in order to avoid any potential familiarity with the tailors. We selected auditors who were between the ages of 25 – 35 from typical middle class

backgrounds. Common profiles included recent graduates, part-time employees, and housewives. Once the auditors were hired, they were given training to explain the setup of the experiment, the details of the tailoring industry, and their particular assignment. The auditors were paid a fixed fee per visit to the tailoring unit that is above the market rate. They were also told that if they deviate from the script they would not be hired for further visits. The auditors were given the information that they are part of a study to understand the market structure and functioning of the tailoring industry. However, auditors were not told what the expected outcome of the study is in order to avoid any "demand effects" in their behavior. Auditors were given the name and address of the shops they would visit, cloth to be stitched for each order, and money to complete the order.

Each tailoring visit varies across three primary dimensions: the type of urgency introduced, whether extra money is offered and the stated locality of the auditor. There are two different types of urgency possible in each visit: "upfront," where the auditor mentions the need for urgent delivery directly after confirming standard delivery terms, and "in-between," where the auditor places an order for standard delivery, then returns a short time later to mention the urgent delivery need. Similarly, there are two different possible monetary offers made with each visit. In the first scenario, "no money," the auditor does not offer any additional money when stating the urgent delivery requirement, but any offer made by the tailor will be accepted. In the second scenario, "extra money," the auditor offers double the initial stitching charge if the tailor initially refuses the urgency. For the locality variation, an auditor either introduces himself or herself to the tailor as recently having moved to the specific neighborhood in which the tailoring shop is located, or as visiting Chennai from out of town to attend a specific event.

Approximately half of the auditors placed orders for a woman's blouse, while the other half ordered a man's shirt. Note that the value of the cloth is at least three times the stitching charges, thus the risk of the auditor holding up the tailor is negligible. The urgency was kept at a pre-determined level of 1.5 – 2 days from the time of placing the initial order. For example, the urgent delivery deadline for an order placed by 11am in the morning would be 6pm on the following day. These specific urgency levels were determined after conducting a number of pilot interviews with tailors. For the tailors, the average time to stitch the requested items was 2 hours. Our aim was to mimic a common transaction that was neither odd enough to draw suspicion nor too easy to stitch so that urgency requirement became negligible.

All auditors were provided training and a detailed script that specified the negotiation rules they were asked to follow while placing the order and collecting the finished product. The visit to each tailor can be summarized as follows: first, the auditor enters the tailor shop and confirms she is talking to the owner/master tailor and that the shop stitches the particular item selected for the particular visit. During this time, the auditor mentions the locality from where she comes. After the introduction, the auditor mentions the need to get an item stitched and inquires about the rate. Once both the stitching rate and delivery days have been provided, the urgency variations are introduced. In the standard upfront visit, the auditor now informs the tailor about the urgent delivery requirement. Under the no money variation, the auditor will wait to see how the tailor responds. If the tailor rejects the urgency, the auditor will exit the store. However, if the tailor counters the urgency request by asking for an extra payment, the auditor will accept, provide the measurements for the garment and proceed with the order. The same applies if the tailor accepts the urgency without any additional payment request. The extra money scenarios vary in that at the time of mentioning the urgency, the auditor offers to pay double the initial

stitching charge. In the extra money scenario, the auditor still waits to see if the tailor voluntarily asks for extra payment before offering additional money.

The bargaining process for the in-between visit is exactly the same except, rather than mentioning the urgency need on the initial visit, the auditor will instead place the order for standard delivery but return to the shop after 45 - 60 minutes to inform the tailor about the urgent delivery requirement.

Note that in all the above mentioned treatments, the negotiation can also be terminated or prolonged at any point by the tailor. There were some cases where the tailor terminated the order before the auditor introduced the urgency by saying that she or he is not taking any new orders.

To monitor auditor performance and detect deviations from the script, one of the auditors' assigned visits is to a tailor who also acts as our representative (the auditors were never informed about this). Furthermore, in some of the other visits, our representatives visit the tailoring unit at the same time as the auditor and observe the bargaining process. Directly after each visit/renegotiation, the auditor is asked to fill out a detailed exit survey that asks about the outcome of the negotiation. The auditor also goes back to the tailor to collect delivery at the agreed upon time and pays the outstanding part of the bill.

2.2. Experiment with Tailoring Shops

As an additional experimental setup to understand real customer behavior, we also conducted a number of treatments in which we partnered with a tailor who assisted us in auditing actual customer visits. For this process, we selected 4 tailors (2 male shops and 2 female shops) at 4 locations throughout Chennai. These locations were selected based on the following characteristics: middle income neighborhoods, with a regular inflow of customers, proximity of

the shop to a major transit point such as a bus stand or railway station, and the standard delivery stitching charge on par with the average rate charged by tailors across Chennai.

In each shop, we instructed our auditor to act as one of the tailors' employees. When a customer entered the store, the auditor observed the interaction between the customer and the tailor. For new customers, the auditor observes the entire interaction to determine whether urgent delivery is required. If so, the tailor executes one of the two treatments. For the first treatment, the tailor initially refuses the urgent request but calls the customer back and agrees to do the urgent delivery with extra money, which is approximately 10% of the standard delivery stitching charge. In the second treatment, the tailor refuses the urgency and does not call the customer back. This is done to test whether the customer will respond to the rejection by offering to pay extra.

Each day, we randomly assigned the order in which the tailor treats new customers with urgency. Once the treatment is completed, we observe the delivery details for all new customers whose urgency request was accepted by the tailor. Since we do not have control over the speed and frequency at which real customers with an urgent need come into these stores, we fixed the number of urgent visits we wanted to observe upfront. We conducted the experiment until that number was reached, which took about 1.5 months.

2. **3. Randomization for Audit Study**

The randomization involves matching 44 auditors – 22 female & 22 male auditors with 221 tailor shops. Each auditor was assigned to visit around 25 tailors, with each tailor visited an average of 5 times. In total, there were 8 standard treatments, which were categorized by variations across three primary variables (type of urgency, customer nativity, and extra payment offer). Among

these standard treatments, the randomization imposed that approximately half of the visits would introduce upfront urgency while the remaining visits were conducted with in-between urgency. We then randomly assigned variation across the remaining two variables to test how reputational concerns and social norms regarding payment affected the transaction.

To achieve the variation in visit characteristics while maintaining a similar script across auditors, the randomization was executed in the following way: first, the tailors were assigned to different types of visits. We also randomized the sequence of the visits. Then, auditors and tailors are randomly assigned to one another in a constrained manner. One auditor and one tailor were randomly drawn from the pool of available candidates and then checked to ensure that the auditor had not been previously assigned to visit a different tailor in that same location group or had visited the same tailor. The result of this randomization is that the 44 auditors were each assigned to visit 20-28 tailors, and each tailor had a range of treatment types assigned.[6] The main dimensions of variation are: (1) the auditor's "nativity" is assigned as "local" and "out of state," where the auditor would state that he or she came to Chennai from a nearby state to attend an event, and (2) The auditor's stated "reason for urgency" is assigned from one of the following: a relative's marriage, engagement, other religious ceremony or sudden out of town travel for official event. The goal was to select commonly used justifications for urgency, yet maintain enough variation such that tailors aren't facing repeated interactions with auditors with similar urgency needs, which may raise suspicion. (3) The auditor's offer for getting urgent delivery was either no money offered or an offer of extra money.

Throughout this process, all characteristics are assigned randomly, in either an unconstrained, constrained or stratified manner. The only aspect of the randomization that is not strictly

[6] The randomization program then checks that the shopper has not been previously assigned to visit a different tailor in that same location group (to avoid the same shopper visiting neighboring tailors), and that the tailor did not have a previously assigned visit by a shopper of that same treatment type.

randomly assigned is the relative timing of the visits, although there is still a great deal of randomly induced variation in this variable. For the most part, visits to different tailors by the same auditor are made in a random order, based on the randomly assigned characteristics of the visits.

3. Data Description

In total, 44 auditors conducted 950 visits to 221 different tailoring shops. The summary statistics presented in Panel A of Table 1 show that the average number of visits per tailor was 4.3, with a standard deviation of 1.33. The average order price was Rs. 81.17. The average number of visits per auditor was 21.59 with a standard deviation of 1.39. Panel B reports the results from the visits conducted when the tailor acted as the auditor. In total, we worked with 4 tailors who received an average of 21.5 customers with urgent delivery requirements during the course of the study. The average order price per tailor was 225 as some of the customers placed orders of multiple items.

In Table 2, we report the detailed price structure of the bargaining outcomes by segmenting the visits by the treatment group. The overall mean initial price for standard delivery was Rs. 81.87. The mean initial price across different treatment groups ranges from Rs. 81 to Rs. 84. As an initial check on the validity of the randomization process, we find no statistically significant differences in the mean figure quoted across the various treatment groups. The extra urgency payment figures show the amount beyond the standard delivery price that the tailor and auditor agreed upon to complete the transaction with the urgent deadline. We code the extra urgency payment as zero in the cases where the tailor accepted the urgency and did not ask for additional money. We find that the average extra urgency payment across different treatment groups ranges

from Rs. 1 to Rs 8. For the treatments where the auditor offers no extra money, the extra urgency payment is a result of the tailor demanding additional money to fulfill the order. We find that the extra urgency payment is very similar across the different treatment groups where the auditor offers no extra money (between Rs. 1 and Rs. 2). Not surprisingly, we also find that the extra urgency payment is higher for the treatments where the auditor offers extra money for the urgent order (between Rs. 3 and Rs. 8), since tailors rarely initiate renegotiations for higher payments.

4. Audit Study Results: Tailors' Willingness to Renegotiate

4.1. Summary Statistics

Table 3 reports the summary statistics across different treatment groups for: acceptance rates, whether the tailors themselves asked for extra money, whether the tailor returned the cloth if the in-between urgency was not accepted, quality of stitching and delay in delivery. Column 2 reports the overall acceptance rate. The overall acceptance for the urgency among tailors varies from 42%-64%. The overall acceptance rate for the treatment groups where the auditor does not offer additional money (upfront urgency, no money and in-between urgency, no money) is 42% and 44% respectively. The overall acceptance rate of urgency when no money is offered is higher for out of state auditors. The acceptance rate for out of state auditors in the case of upfront urgency, no money, is 51% and is 49% in the case of in-between urgency, no money. However, when comparing treatment groups across different types of urgency (upfront vs. in-between), the acceptance rates are similar. That is, for comparable treatment groups, we do not find differences in acceptance rates based on whether it is an upfront urgency versus an in-between urgency.

We find that the overall acceptance rate of tailors in treatments where the auditors offer extra money is higher than the treatments where no extra money is offered by the auditor. To

determine the percentage increase in acceptance due to the extra money offer, we first compute the acceptance percentage for urgent delivery before the auditor offers extra money. Note that in the treatments where the auditor offers extra money, the auditor first reveals the urgency and waits to see if the tailor accepts the urgency without any additional charge. The auditor only offers extra money for the urgency after the tailor declines to fulfill the order without any additional charge. As shown in Column (3), the acceptance percentage of the urgent delivery before the auditor offers extra money is very similar across comparable treatment groups. The acceptance rate is between 42%-44% for local auditors, while that for out of state auditors is between 46%-51%. Column 4 reports the percentage increase in the acceptance rates when extra money is offered. For the case of upfront urgency when extra money is offered, we find that the acceptance rate increases from 44% to 57%. There is a 30% increase in the acceptance rate when extra money is offered. We find a similar pattern for the other treatment groups.

We also examine the percentage of visits where the tailors themselves ask for extra money as soon as the urgency is mentioned (and consequently before the auditor has a chance to offer). Column 5 reports these results. We find that the fraction of visits where tailors themselves ask for extra money for the urgency is very small (between 2%-8%). The final three columns of Table 3 look at differences in service outcomes across the treatment groups. Interestingly, we find that in a large fraction of the visits, tailors return the cloth when they refuse an urgent order. While in the upfront case, this is not relevant, in the case of the in-between treatment, the tailor has a choice to say that the cloth is cut and therefore cannot be returned. However, as seen from Column 6, very few tailors exercise this option. We also find the quality rating of the finished product, which was conducted by two external tailors hired to provide ratings on a 1 to 5 scale (5 indicating an order stitched the highest quality) is very similar across treatment groups (Column

7). Likewise, there was little variation in the mean delay in delivery beyond the agreed upon time, which ranged from 0.15 to 0.35 hours, depending on the treatment group (Column 8).

5.2. Regression Analysis

We further examine whether there are significant differences in contracting and bargaining outcomes once we account for auditor and tailor specific differences using a regression framework. In Table 4, we use different measures of the outcome from the bargaining process as dependent variables and regress these on indicator variables for the different treatment cells (in-between or upfront urgency, extra money offered or out of town customers). We include tailor and auditor fixed effects in all regressions and also control for the number of delivery days stated by the tailor to fulfill a normal order in order to account for tailors who are busier upfront.[7] Columns 1 and 2 of Table 4, examine whether there are significant differences across treatment cells in the initial price quoted by the tailor. This is the price stated by the tailor upfront before the auditor mentions any urgency (neither upfront urgency nor in-between urgency, nor an offer of extra money). We would expect to find no difference in the initial price across treatment cells, since, at this point, the tailor has not been exposed to differences in auditor behavior yet. As can be seen from Columns (1) and (2), we do not find any significant differences in the initial price across upfront and in-between urgency cases, or afterwards, when extra money was offered to the tailor. This is important since it confirms that our auditors did not involuntarily behave differently across treatments upfront. Interestingly, there are no significant differences in the initial price that tailors ask from local versus out of state customers (i.e. auditors). This suggests that tailors perceive the market as competitive.

[7] In our treatments, the auditors first ask the tailor for the price and the number of delivery days for a normal order before revealing the urgency.

In Column 3 and 4, we look at the likelihood of a tailor accepting the urgent order immediately after the auditor reveals the urgency. We do not find any significant differences in the likelihood of acceptance between in-between and upfront urgency. However, the acceptance rate is significantly higher for out of state auditors, and the coefficient on the extra dummy is positive (7.8%) and significant at the 5 percent level. When interacting the out of state dummy with the in-between treatment dummy in Column 4, the coefficient on the interaction term is negative and close to zero. A possible reason for this higher acceptance rate might be that tailors do not have to worry that they are setting a precedent with the out of state auditor for delivering urgent orders in the future without an extra charge, since the out of state auditor is not expected to come back. In contrast, this consideration might be more relevant for local customers. An alternative explanation of why tailors are more likely to accept urgent orders upfront from out of state auditors would be that tailors feel pity (or altruism), since outsiders might not be able to find a replacement tailor. However, that explanation seems less convincing, since as discussed later, we find that for in-between urgencies, tailors themselves are more likely to initiate renegotiations with out of state auditors and demand a higher price. In Columns 3 and 4, we also find that tailors who state a higher number of days for the delivery of a normal order are less likely to accept the urgent order.

We then examine whether tailors independently ask for additional money from the auditors once they state the urgency, but importantly, before the auditor offers extra money. In Columns 5 and 6, we do not find any significant difference in the likelihood of the tailor demanding additional money between the upfront and the in-between urgency. Given that in the in-between urgency, tailors have higher bargaining power and have higher costs of terminating the order, one would have expected the likelihood of tailors demanding money to be higher. This suggests that tailors

do not use the additional bargaining power in the in-between urgency case to extract surplus from the customers. Tailors are willing to forego the order rather than demand a higher price to fulfill the urgency. The reluctance by tailors to initiate a renegotiation and demand a higher price could be driven by norms or reputational concerns. However, in Column 6, we find that tailors are more likely to demand additional money from out of state customers in the in-between urgency treatments. These results suggest that reputation concerns play some role in why tailors are reluctant to initiate a price renegotiation for local customers but might be more willing to use the additional bargaining power with out of state auditors. However, even in the case of out of state auditors, the overall likelihood that tailors ask for extra money independently is only 6%. So even in the case of out of state auditors, social norms seem to constrain the tailors in using their additional bargaining power.

One concern in interpreting the reluctance of tailors to initiate a renegotiation could be that they have capacity constraints, or extremely high disutility from working overtime. To address these alternative explanations we introduced an additional treatment arm where auditors offer extra money (double the initial price) in case the tailor refuses to fulfill the urgent order. If capacity constraints and the like are the main reason for the tailors to turn down the order, then auditors offering a higher price should not significantly affect the acceptance rate. However, if concerns about reputation and violation of social norms constrain the tailor from proposing a higher price, then the proactive offer from the auditors should lead to higher acceptance rates

In Table 5, we therefore examine if the acceptance rates of urgent orders is higher when the auditor offers the tailor additional money for the urgency. In Columns 1 and 2, we create a dummy variable for the ultimate acceptance rate of a treatment after all the steps have been completed. For example, in an in-between urgency case this variable is one if the tailor

ultimately delivers the stitching with expedited delivery. We see in Column 1 that the acceptance rate for the urgent order is significantly higher by 12 % when the auditor offers extra money. As before, we find a higher ultimate acceptance rate for out of state customers. The magnitude of the effect is identical to the initial difference estimated in Table 4. In Column 2, we now add interaction terms for in-between urgency and out of state and in-between urgency and extra money, and find that the estimated coefficients on both interaction terms are close to zero and insignificant. This suggests that there is no differential effect of offering extra money in the upfront or the in-between urgency case. This suggests that even in case of upfront urgencies, tailors do not initiate a price renegotiation but, rather, turn down the request unless the customer voluntarily offers a higher price. As in Table 4, we do not find significant differences in the overall acceptance rate between out of state and local auditors when there is an in-between urgency. Overall, these results suggest that capacity constraints or extreme preferences against overtime work cannot be the sole driver for the reluctance by tailors to renegotiate. Rather, if the auditor initiates the offer to renegotiate, the tailors are happy to oblige to fulfill the urgent delivery with a 12% higher likelihood.

In Columns 3 and 4, we now repeat the same regression set up but use the total amount paid for the ultimate completion of the order as a dependent variable. The total amount paid is the sum of initial price plus the extra payment for urgency. The sample is limited to those treatments where urgent orders (either upfront or in-between) are accepted. This reduces the sample size to almost half. Not surprisingly, in Column 3 we find that the total amount paid is higher for the treatments where extra money is offered. The magnitude is almost Rs. 8, which is equivalent to a 10% higher price. As discussed before, we do not find significant differences in the total amount paid between out of state and local auditors and neither for upfront versus in-between urgencies.

These (non) results are driven by the reluctance of the tailors to initiate renegotiation themselves. We also find that the total amount paid is higher for tailors that state a higher number for the initial delivery days.

Finally, in Columns 5 and 6, we look separately at the amount of extra payment (above and beyond the initial price) demanded by tailors across different treatment conditions. Note that the payment to the tailors does not mechanically increase when auditors offer the tailor additional money in the "extra money" treatment, since usually, tailors do not accept the entire amount offered. Instead, they on average take only a 40% upcharge, even though they are offered more. In line with what we saw before, Columns 5 and 6, show that extra payment for urgency is only higher for the treatments where the auditor offers extra money. But there are no significant differences in the amount of extra payment between upfront and in-between urgencies. And as before there is no significant difference between out of state and local auditors

Overall, the results in Tables 4 and 5 suggest that tailors are reluctant to initiate renegotiations and are willing to either forego an order or accept the urgency without negotiating, rather than demand a higher price. It is in particular surprising that the tailors do not exploit their increased bargaining power in the in-between urgency to extract surplus. However, when the auditor offers a higher price for the urgency, tailors are willing to fulfill the order for an extra payment.[8] Interestingly for out of state auditors, tailors are slightly more likely to initiate a price renegotiation during in-between urgency. They are willing to ask for more money from out of state customers when there is an in-between urgency. However, even in this case the magnitude of the effect is small, since it only happens in five percent of cases. Taken together, these results

[8] One question that arises is why tailors do not post a price schedule for urgency. From interviews with tailors we found that posting a price schedule for urgency can lead to scheduling problems for tailors.

suggest that tailors' reluctance to renegotiate prices leads to ex post inefficiencies in renegotiation and breakdown of trade.[9]

To obtain a rough estimate of the cost incurred by the customer from the breakdown of trade, we do a back of the envelope calculation. The customer has to bear the cost of transportation of going to another tailor. Normally, given that tailors are not concentrated in the same neighborhood, this entails the customer commuting by a rickshaw, spending approximately Rs. 40. In addition to this, there is the hassle cost of finding another tailor who is likely to accept the urgent order. Given that we observe that the probability of a tailor accepting the urgent order without additional money is 0.5, the customer, on average, would have to visit two tailors to get the urgent order accepted. In effect, the customer on average spends an additional amount of Rs. 40 (50% of the initial stitching charge). Thus, the amount spent is higher than the additional money charged by the tailor.

6. Customer Behavior in Equilibrium

However, an important question that arises is whether in equilibrium the reluctance of tailors to renegotiate leads to a distortion in the first best outcome. If actual customers in the marketplace offer additional money to the tailor whenever they have an urgent demand then there might not be a distortion from the first best outcome.

To test this alternative hypothesis we partnered with 4 tailors who assisted us in auditing actual customer visits. We asked these tailors to conduct the following two treatments among new customers who enter with an urgent request. In the first one, the tailor does not initiate the renegotiation but refuses to take on the urgency, which allows us to see if customers offer extra payment to signal true urgency. In the second treatment, the tailor initially refuses the urgent

[9] In unreported regressions, we also find that there is no difference in the quality of stitching or the time to delivery across the different treatment arms. There is some suggestive evidence that tailors are more likely to have a delay in delivery if the auditor is out of state. But they results are only significant at the 10% level.

request but then asks for an extra charge to do the urgent delivery (approximately 10% increase over the standard stitching charge). This allows us to verify that even customers who are willing to pay an additional charge do not offer the price increase in equilibrium. The assignment to the two treatment arms was randomized. See the detailed description of the implementation in the experimental design section above.

From Table 6 (Row 1), we can see that customers never offer a higher price out of their own volition. Out of 43 incidents where the customer came into the shop to request the expedited stitching of a garment, there was not a single visit where the customer suggested to pay a higher price once the tailor refused to fill the order (without an upcharge). This result suggests that customer-initiated renegotiations are not the norm. In addition, in Row 2 of Table 6, we see that a large majority of the customers who have an urgent need are willing to pay the additional charge. Only 5 out of 41 customers decline to pay the extra charge, the other 36 paid without a complaint. We also do not observe that customers are upset or "aggrieved" when the tailor asks for extra money. Note that we do not observe whether the likelihood of these customers (of whom the tailor demanded additional money) coming back to the tailor to place subsequent orders is lower. These results rule out an equilibrium where customers always offer extra money in order to signal that they have a truly urgent order. Instead, it appears that tailors' reputational concerns prevent them from initiating ex post efficient renegotiations and rather accept breakdown of trade.

7. Conclusion

In this paper we show that contracting parties are willing to allow the breakdown of ex post efficient trade in order not to be seen as price gouging. Reputational concerns or norms against

opportunistic behavior can lead to distortions in ex post efficient trade if parties have unforeseen shocks. Our experiment with tailoring shops in South India shows that tailors do not use the increase in their bargaining power to initiate a higher price. Instead, tailors either fill the urgent order with no additional upcharge or, state that they are unable to fulfill the order in the shorter timeframe and are even willing to give the cloth back to the customer so that they can find another tailor.

However, when offered a higher price by the customer, a large fraction of tailors were happy to fill the urgent order. This result suggests that without the customer offering the markup, tailors forego an efficient renegotiation option and trade breaks down. We also find that tailors are slightly more likely to initiate a renegotiation with out of state customers, but the magnitude of this effect is small.

These results put into question the notion that ex post efficient renegotiation can easily be achieved and will always lead to ex post efficient outcomes. In contrast, it appears that social norms against opportunistic behavior and reputational concerns can prevent such ex post efficient trades from occurring.

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Table 1: Sample description

Table 1 reports summary statistics for the visits conducted during the experiment. Panel A presents the results from the first experiment where auditors operated as customers to the tailor shops. Average number of visits refers to the visits received per tailor and conducted per customer. For each tailor, this figure is analogous to the number of treatments. The average order price per treatment is the mean initial price quoted for standard delivery.

Panel B presents the summary statistics from the visits conducted where the tailor acted as the auditor.

Panel A: Auditor as Customers

Group	Obs.	Avg no of visits	Median no of visits	Average price per order
Tailors	221	4.30	4	81.17
		(1.33)		(26.46)
Auditors	44	21.59	22	81.99
		(1.39)		(22.92)

Panel B: Auditor as Tailor

Group	Obs.	Avg no of urgent customers	Median no of urgent customers	Average order price per tailor
Tailors	4	21.5	19	225.68
		(14.55)		(129.85)

Table 2: Payment Descriptives

Table 2 reports summary statistics on the price structure of the negotiations for visits conducted in Experiment 1, where the auditor assumes the role of the customer. Initial Price refers to the price quoted by the tailor for non-urgent delivery. Extra Urgency Payment is the amount beyond the standard delivery price agreed upon to complete the urgent delivery.

Treatment		Initial Price		Extra Urgency Payment	
	Obs	Mean	Std. Dev.	Mean	Std. Dev.
	(1)	(2)	(3)	(4)	(5)
Upfront urgency, no money, local	149	80.6	27.6	1.8	7.6
In-between urgency, no money, local	146	83.2	28.2	0.3	2.0
Upfront urgency, extra money, local	98	82.8	30.9	4.0	12.4
In-between urgency, extra money, local	95	83.5	29.4	5.1	14.4
Upfront urgency, no money, out of state	143	81.3	27.2	1.4	6.1
In-between urgency, no money, out of state	145	80.7	28.4	1.1	5.0
Upfront urgency, extra money, out of state	71	80.9	26.4	3.0	10.9
In-between urgency, extra money, out of state	75	83.1	27.1	7.6	20.2

Table 3: Acceptance Rates and Delivery Outcomes

Table 3 reports acceptance rates and delivery outcome measures for the treatment groups. Accept Urgency is the percentage of tailors who accept the urgent order (after all the treatment interventions have been conducted). Urgency Accepted Before Extra Money is the percentage of tailors who accept the urgent order before the auditor has the chance to offer an extra urgency payment. Urgency Accepted After Extra Money is the percentage of tailors accepting the urgent order only after the auditor offers an urgency payment. Tailor Asked For Extra Money is the percentage of tailors who preempt the auditor's offer by themselves asking for an extra urgency payment immediately. Percent Returning Cloth When Rejecting Urgency measures the percentage of tailors who return the stitching material when rejecting the auditor's urgency requirement under in-between treatments. Mean Quality Rating represents the mean rating assigned to the finished product as assessed by two external tailors on a scale of 1 (lowest) to 5 (highest). Mean Delay is the number of hours beyond the agreed upon urgent delivery time that the final product was ready to be collected.

Treatment	Total Obs.	Accept Urgency	Urgency Accepted Before extra money	Urgency Accepted After extra money	Asked For Extra Money	% Returning Cloth When Rejecting Urgency	Mean Quality Rating	Mean Delay (Hours)
Upfront urgency, no money	153	42%	42%	--	7%	--	3.38	0.15
In-between urgency, no money	149	44%	44%	--	2%	98%	3.48	0.34
Upfront urgency, extra money	101	57%	44%	13%	5%	--	3.51	0.21
In-between urgency, extra money	100	58%	43%	15%	6%	91%	3.24	0.23
Upfront, no money, out of state	148	51%	51%	--	6%	--	3.51	0.25
In-between, no money, out of state	148	49%	49%	--	5%	93%	3.54	0.24
Upfront urgency, extra money, out of state	73	55%	47%	8%	3%	--	3.67	0.35
In-between urgency, extra money, out of state	78	64%	46%	18%	8%	100%	3.54	0.23

Table 4: OLS Regression of Initial Price, Urgency Acceptance before money was offered and whether Tailor asked for money

Table 4 reports results from an OLS regression of Initial Price, Urgency Acceptance before money was offered and whether Tailor asked for money on a group of dummies representing the variations in the treatment groups. . Initial Price refers to the price quoted by the tailor for non-urgent delivery. Urgency Accepted Before Money is a dummy variable that takes the value of one when the tailor accepts the urgent order before the auditor has the chance to offer an extra urgency payment. Tailor Asked for Extra Money is a dummy variable that takes the value of one for tailors who preempt the auditor's offer by themselves asking for an extra urgency payment immediately. In-between is a dummy that takes the value of one if auditor returned to the tailoring shop to introduce the urgency and zero if the auditor introduced the urgency upfront. Out of State is a dummy that takes the value of one if the auditor introduces himself or herself as visiting from out of the area and takes a value of zero if the auditor instead mentions that he or she recently moved to the area. Initial Delivery Days Stated is the number of days stated by the tailor to complete the order under standard delivery terms. Extra is a dummy that takes the value of one if the auditor offers double the initial stitching charge to complete the urgent order and zero otherwise. Note that the outcome varibles in these regressions are captured before the auditor makes an extra money offer. Robust standard errors for all coefficients are reported in parentheses. The symbols ***,**,* indicate significance levels of 1%, 5% and 10%, respectively.

	Initial Price quoted	Initial Price quoted	Urgency Accepted Before Money	Urgency Accepted Before Money	Tailor Asked For Extra Money	Tailor Asked For Extra Money
	(1)	(2)	(3)	(4)	(5)	(6)
In-between	0.104	0.272	-0.0004	0.006	-0.006	-0.029
	(0.518)	(0.765)	(0.028)	(0.040)	(0.013)	(0.019)
Out of State	0.650	0.828	0.069**	0.075*	0.002	-0.023
	(0.591)	(0.859)	(0.033)	(0.044)	(0.016)	(0.022)
In-between *Out of State		-0.361		-0.013		0.049*
		(1.129)		(0.060)		(0.028)
Extra	0.438	0.441	-0.045	-0.044	-0.010	-0.010
	(0.626)	(0.628)	(0.032)	(0.032)	(0.014)	(0.014)
Initial Delivery days	0.063	0.061	-0.023***	-0.023***	-0.0001	0.0001
	(0.119)	(0.118)	(0.005)	(0.005)	(0.002)	(0.002)
Initial Price			0.002	0.002	-0.002**	-0.002**
			(0.002)	(0.002)	(0.0009)	(0.0009)
Adj R2	0.922	0.922	0.287	0.286	0.264	0.267
Auditor Fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Tailor Fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Number of Obs	912	912	912	912	912	912

Table 5: OLS Regressions of Urgent Order Acceptance, Total Price and Extra Money on Treatment Dummies

Table 5 reports results from an OLS regression of overall acceptance of urgent order, total price paid and extra money paid on a group of dummies representing the variations in the treatment groups. Overall acceptance is a dummy that takes the value of 1 if the tailor accepts the urgent order (this includes acceptance of the order after the extra money offer). Total Price paid is the total amount paid by the auditor to complete the urgent order (initial price + extra payment for urgency). Extra money paid only includes the extra amount paid beyond the initial price for the urgent order. Note that in columns 3 to 6, we only include visits where the urgent order was accepted. In-between is a dummy that takes the value of one if auditor returned to the tailoring shop to introduce the urgency and zero if the auditor introduced the urgency upfront. Out of State is a dummy that takes the value of one if the auditor introduces himself or herself as visiting from out of the area and takes a value of zero if the auditor instead mentions that he or she recently moved to the area. Extra is a dummy that takes the value of one if the auditor offers double the initial stitching charge to complete the urgent order and zero otherwise. Initial Delivery Days Stated is the number of days stated by the tailor to complete the order under standard delivery terms. Robust standard errors for all coefficients are reported in parentheses. The symbols ***,**,* indicate significance levels of 1%, 5% and 10%, respectively

	Overall Acceptance	Overall Acceptance	Total Price paid	Total Price paid	Extra money paid	Extra money paid
	(1)	(2)	(3)	(4)	(5)	(6)
In-between	0.015	0.019	3.386	0.614	0.926	-1.967
	(0.028)	(0.050)	(2.281)	(4.570)	(1.182)	(1.901)
Extra	0.097***	0.117**	7.430***	7.047*	5.248***	4.569*
	(0.031)	(0.058)	(2.467)	(3.819)	(1.520)	(2.384)
Out of State	0.067**	0.094*	1.367	-3.634	0.520	0.120
	(0.033)	(0.053)	(2.467)	(5.072)	(1.446)	(2.249)
In-between * Extra		-0.009		-5.652		1.282
		(0.081)		(5.878)		(3.003)
In-between * Out of State		-0.031		5.193		1.169
		(0.072)		(6.162)		(2.582)
Extra*Out of State		-0.081		-0.547		-5.891
		(0.097)		(7.710)		(4.023)
In-between * Extra *Out of State		0.092		14.529		10.480*
		(0.132)		(9.362)		(5.452)
Initial Delivery days	-0.026***	-0.026***	1.317*	1.373**	1.338**	1.294**
	(0.005)	(0.005)	(0.693)	(0.648)	(0.615)	(0.570)
Initial Price	0.001	0.001			-0.154	-0.127
	(0.002)	(0.002)			(0.158)	(0.160)
Adj R2	0.307	0.304	0.668	0.676	0.345	0.368
Auditor Fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Tailor Fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Number of Obs	912	912	476	476	483	483

Table 6: Tailors as Auditors

Table 6 presents the results from the visits conducted where the tailor acted as the auditor. Refuse, Then Ask for Extra Money refers to the treatment where the tailor initially refuses the customer's urgent delivery requirement, then asks for 10% additional charge to fulfill the urgent order. Refuse, Don't Ask for Extra Money refers to the treatment where the tailor refuses the urgency request and does not counter with an additional money offer. Cust. Leaves is the number of observations where the customer rejects the extra urgency payment or doesn't make a counter offer. For the treatment Refuse, Then Ask for Extra Money, Cust. Agrees is the number of observations where the customer accepts the tailor's offer and pays the additional charge and Cust Leaves is the number of observations where the customer does not agree to pay the additional amount and leaves. For the treatment Refuse, Don't Ask for Extra Money, Cust. Agrees is the number of observations where the customer offers the tailor extra money to meet the urgency demand. Cust Leaves is the number of observations where the customer does not offer extra money to meet the urgency demand and leaves the store.

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		No. Obs	
Treatment	Total Obs.	Cust. Leaves	Cust. Agrees
Refuse, Then Ask for Extra Money	41	5	36
Refuse, Don't Ask for Extra Money	43	43	0