

Fairness as a Constraint in the Real Estate Market

Moses L. Pava
Jeremy Pava
Joel Hochman

ABSTRACT. Community standards, ethical norms, and perceptions of fairness often serve as constraints on pure profit maximizing behavior. Consider the following examples: Most hardware stores refrain from raising prices on snow shovels after a major snow storm, even where short term profits might be increased. Most employers do not lower wages for existing employees, even as unemployment in the area increases. Automobile dealerships rarely raise sticker prices to cope with the long waiting periods for a popular model. Each of these anomalies is consistent with the proposition that firms increase profits subject to fairness constraints.

This paper examines perceptions of fairness in the residential real estate industry and explores how community standards affect economic decision-making. The residential real estate industry is unique. One party to the transaction (the landlord) frames decisions as pure business decisions. The other party to the transaction (the tenant) frames decisions more broadly. While a tenant's choice of apartments is in part viewed as a business decision, tenants consider a broad spectrum of non-business issues, as well.

This disjunction between landlord and tenant perceptions can lead to unique ethical quandaries and can explain otherwise anomalous economic behavior

in the industry. The hypothetical case examined in this paper is based on a frequently encountered situation in the industry. The paper concludes with practical suggestions for managers.

Economists usually assume firms behave as if they maximize profits subject only to legal and budgetary constraints. For many purposes this core assumption of economics provides interesting, useful, and important results. Nevertheless, it is often an incomplete description of firm behavior. Ironically, those firms which adopt the economists' description as a prescriptive mandate may actually perform worse than other firms (Pava and Krausz, 1996).

Kahneman, Knetsch and Thaler (1986, hereafter KKT) have provided persuasive survey evidence suggesting that maximizing firms also consider "fairness" constraints. Following Akerlof (1979), Solow (1980), and Okun (1981), the authors suggest that fairness constraints explain why many markets fail to clear in the short run and why suppliers often describe a cut in price as a "discount" rather than as a reduction in the list price. The authors claim no necessary normative status for fairness constraints. Rather fairness is treated as a kind of community norm and is defined operationally as "a substantial majority of the population studied thinks its fair" (p. 729).

To document the existence of fairness constraints KKT presented a number of short business scenarios to a random sample of Canadian residents and asked respondents to rate the scenarios as Very Unfair, Unfair, Acceptable, or Completely Fair. For example, the authors asked respondents to rate the following scenario:

Moses L. Pava is Professor of Accounting and holds the Alvin Einbender Chair in Business Ethics at Yeshiva University's Sy Syms School of Business. His most recent book is Business Ethics: A Jewish Perspective.

Jeremy Pava is controller for Aspen Square Management based in Springfield, MA. He is a Phi Beta Kappa graduate of Brandeis University in Waltham, MA.

Joel A. Hochman is an Assistant Professor of Accounting, Business Law, and Taxation at Yeshiva University's Sy Syms School of Business in New York City. He is also a rabbinical student at the same institution. His research in financial accounting and taxation has been published in various journals.

A hardware store has been selling snow shovels for \$15. The morning after a large snowstorm, the store raises the price to \$20 (p. 728).

The vast majority of respondents, 82%, rated this decision as either Completely Unfair or Unfair. Only 18% rated the action as Acceptable or Completely Fair. In this scenario, the hardware store is attempting to capture profits in response to an exogenous increase in demand spurred on by the unpredictable snowstorm. Apparently, most respondents view such profits, resulting from the mere transfer of wealth from customers to the firm, as tainted in some way. Not all profits are alike. From a pure free market perspective – with no vocabulary to describe community norms of fairness – such results are difficult, if not impossible, to interpret.

Simple fairness

KKT suggest that this scenario and others provide strong evidence for the following formal proposition:

“The cardinal rule of fair behavior is surely that one person should not achieve a gain by simply imposing an *equivalent* loss on another” (p. 731, emphasis added).

We will refer to this proposition as *simple fairness*. In the snow shovel example, the \$5 gain to the firm is taken directly from the representative customer who now pays an additional \$5. The firm itself has nothing to do with the snowstorm and its own costs are unaffected. Had the price increase been justified as a result of a \$5 increase in wholesale prices (or even a relatively smaller increase), respondents would be much less likely to rate the firm’s action as unfair. In this alternative formulation of the scenario, the firm itself is not profiting and therefore there is no violation of *simple fairness*.

The proposition is labeled here as simple for two reasons. 1) It applies across a wide spectrum of diverse situations; and 2) at least theoretically, it is straight-forward to use. If A has knowledge of the loss he is imposing on B, A must forgo the equivalent profit. This proposition suggests the

existence of a bright line dividing fair and unfair behavior. In KKT’s words, “Transactors have an entitlement to the terms of the reference transaction and firms are entitled to their reference profit. A firm is not allowed to increase its profits by arbitrarily violating the entitlement of its transactors to the reference price, rent, or wage” (p. 729). In the case at hand, the reference profit is the profit earned in the absence of the snow storm and the reference price is the original price of the snow shovels.

Two caveats are in order here. First, although it is true that the proposition holds across a wide spectrum of diverse situations, it is by no means universal. Consider, for example the following scenario:

A small company employs several workers and has been paying them average wages. There is severe unemployment in the area and the company could easily replace its current workers with good workers at a lower wage. The company has been losing money. The owners reduce the current workers’ wages by 5 percent (KKT, p. 733).

Almost 70% of respondents rated this behavior as Acceptable or better, and only about 30% perceived this as Unfair. Apparently, what makes this scenario unique is the additional fact that the company has been losing money. In fact, when the otherwise identical scenario reads “The company has been making money”, more than 75% of respondents rate it as Unfair. Second, even if theoretically the use of this proposition is straight-forward, in practice it is often difficult to apply. Unlike the snow shovel example, in many real-life situations business decision-makers simply don’t know the precise dollar amount of losses imposed on customers, employees, and others. In spite of these limitations, the notion of *simple fairness* is useful and ubiquitous.

Simple fairness versus complex fairness

Simple fairness is not restricted to customer markets, but holds in employer and employee relationships and in landlord and tenant relationships, as well. For example, 83% of respon-

dents rated the following scenario either Unfair or Completely Unfair:

A small photocopying shop has one employee who has worked in the shop for six months and earns \$9 per hour. Business continues to be satisfactory, but a factory in the area has closed and unemployment has increased. Other small shops have now hired reliable workers at \$7 an hour to perform jobs similar to those done by the photocopying shop employee. The owner of the photocopying shop reduces the employee's wage to \$7 (KKT, p. 730).

Similarly, more than 90% of respondents rated the following scenario from the real estate industry as Unfair or Completely Unfair:

A landlord rents out a small house. When the lease is due for renewal, the landlord learns that the tenant has taken a job very close to the house and is therefore unlikely to move. The landlord raises the rent \$40 per month more than he was planning to do (KKT, p. 730).

As in the snow shovel example, these two cases represent merely a transfer of wealth from one party to another. In the photocopying example, the firm captures the full benefit of the employee's \$2 an hour loss, and in the landlord case the landlord keeps the extra \$40 per month which the tenant must now pay. Both of these cases clearly violate the proposition that one person should not achieve a gain by simply imposing an equivalent loss on another.

The existence of community norms of fairness in a wide variety of economic settings, as documented by KKT, suggests an interesting follow-up question. If *simple fairness* serves as a constraint, or a potential constraint, on profit maximizing behavior, perhaps an even more restrictive rule of fairness might govern at least some economic transactions?

This study extends the KKT paper by examining the following more restrictive proposition which we label *complex fairness*.

One person should not achieve a relatively large gain by imposing a relatively small loss on another.

This proposition suggests that under certain carefully prescribed circumstances fairness constraints

will cause firms not only to forgo a profit when an equivalent loss is imposed on another party, but firms will forgo relatively large profits when a relatively small loss is imposed on another party. We label this as *complex fairness* for two distinct reasons. 1) To a far greater degree than *simple fairness*, we expect this proposition to be highly dependent on context. It is unlikely that *complex fairness* applies across the board to the same extent that *simple fairness* does. More specifically, we expect this proposition to hold primarily in those situations where A is clearly superior to B in some relevant characteristic, especially wealth. 2) This proposition is ambiguous and more difficult to use than the first proposition. Here, there is no bright line that naturally divides fair and unfair behavior. Managers, on a case by case basis, need to judge the meaning of "a relatively large gain" and "a relatively small loss." Easily discernible and non-controversial "reference profits" and "reference prices" are difficult to discover and apply.

Methodology and results

The specific questions of this paper can now be succinctly stated as follows: Is complex fairness ever a community standard? And, if so, how large is a "relatively large gain" and how small is "a relatively small loss"? To answer these questions, we administered the following questionnaire (it includes 2 cases) to 101 business student respondents. All respondents had some exposure to time value concepts. These scenarios, reproduced in full below, are hypothetical cases designed to capture a realistic and pervasive problem in the real estate industry. In virtually all rehab projects managers choose whether or not to factor in costs imposed on non-contracting third parties. The hypothetical example which follows is purposely exaggerated in order to highlight the underlying ethical dilemma, but the essence of the choice is retained.

Real Estate Scenarios Case 1

You are managing a residential apartment complex in a small, aging, industrial town on the

Massachusetts and Vermont border. Your company (of which you are a 10% partner) paid \$1 000 000 cash for the complex which consists of 100 separate housing units. The apartments require repairs. You are asked to choose between the following two rehabilitation projects:

Project A – Complete “Rehab”:

The company incurs an additional \$1 000 000 of costs to repair and modernize the apartment complex. Repairs are made both externally and internally. After completion of the rehab (approximately 1 year), rents will be raised for each of the 100 housing units from \$4000 per year (current rental rates) to \$5000 per year. You are certain occupancy will be 100% for all future periods. Prevailing interest rates are 5%. (*HINT:* The present value of a perpetuity (an annuity of infinite length) is equal to the rent divided by the interest rate [in this case 5%]).

Project B – Partial “Rehab”

The company incurs an additional \$250 000 of costs to repair and modernize the apartment complex. Repairs are made both externally and internally, but are generally cosmetic changes. After completion of the rehab (approximately 1 year), rents will be raised for each of the housing units from \$4000 per year (current rental rates) to \$4250 per year. You are certain occupancy will be 100% for the foreseeable future. Prevailing interest rates are 5%. (*HINT:* The present value of a perpetuity (an annuity of infinite length) is equal to the rent divided by the interest rate [in this case 5%]).

REQUIRED: Assuming you must choose either PROJECT A or PROJECT B, which would you choose? Circle one:

PROJECT A PROJECT B

If you selected PROJECT B, – stop here.

Case 2

This case is the same as above, except if you choose PROJECT A, the 100 current tenants will not be able to afford the new, higher rents. Each of the 100 tenants will incur a relocation fee of \$15 000.

A-REQUIRED: Assuming you must choose either PROJECT A or PROJECT B, which would you choose? Circle one:

PROJECT A PROJECT B

If you selected PROJECT A, – stop here.

B-REQUIRED: If you are still participating in this experiment, in the absence of any relocation fees you selected PROJECT A, and with a \$15 000 relocation fee you switched your answer to PROJECT B. Choose any dollar amount between \$1 and \$14 999 for the relocation fee which would cause you to be indifferent between PROJECT A and PROJECT B. Write in the amount here
\$ _____

Case 1, above, is straight-forward and is included as a device to screen out non-profit maximizing respondents.¹ Respondents are expected to compare the net present values of Projects A and B. In the absence of any external costs, rational respondents will choose that project which yields the highest net present value. Since the choice is between Projects A and B only, rational investors focus only on the “additional revenues” and the “additional costs” to determine the net present values. In this case, the real estate company raises rents \$1000 per unit times the 100 separate housing units, or \$100 000 in total. For simplicity, the case assumes that occupancy will be 100% for all future periods. The present value of the additional revenues is therefore \$2 000 000 (\$100 000 divided by the assumed interest rate of 5%). If we subtract the additional \$1 000 000 of costs needed to repair and modernize the apartment for the complete rehab, we are left with a net present value of \$1 000 000 for Project A. The net present value for Project B, described as a partial rehab, can be calculated using the exact same procedure. The net present value for Project B is \$250 000. Thus Project A, the full rehab, is the profit maximizing choice. Project A is \$750 000 more valuable than Project B. Not unexpectedly, the vast majority of our sample, made up entirely of accounting students with at least some exposure to present value concepts, chose Project A. In fact, nearly 80% (80 out of 101) chose the profit maximizing alternative.

These 80 respondents, the profit maximizing respondents, were then asked to consider Case 2. Case 2 is identical to Case 1 in all respects except one. The 100 current tenants each incur a relo-

cation fee of \$15 000 as they can no longer “afford the new, higher rents.” Importantly, occupancy is still assumed to be 100% for all future periods. More than 71% of respondents (statistically significant) switched from Project A to Project B. This result indicates that even profit maximizers factor in external costs, when those external costs are relatively high. This result is consistent with those results obtained by KKT discussed above and is expected in a community which, at minimum, accepts some notion of *simple fairness*. In this case, we describe the \$15 000 relocation fee, or the total relocation fee of \$1 500 000, as relatively high because it is twice the difference between the net present values of Projects A and B. In other words, respondents who choose Project A, in Case 1, and Project B, in Case 2, are foregoing a profit of \$750 000 in order to avoid imposing a total cost of \$1 500 000 on current tenants. Remember, if *simple fairness* holds, it suggests that one person should not achieve a gain by imposing an equivalent loss on another. This certainly implies that one person should not achieve a gain of \$x by imposing a loss of 2 times \$x on another party, as is the case here.

Requirement B in Case 2 is an attempt to formally distinguish between *simple and complex fairness*. Requirement B reads, “If you are still participating in this experiment, in the absence of any relocation fees you selected PROJECT A, and with a \$15 000 relocation fee you switched your answer to PROJECT B.” It asks respondents to choose any dollar amount between \$1 and \$14 999 as the relocation fee which would cause them to be indifferent between Projects A and B. The mean response was \$5316 (statistically smaller than \$7500). The accompanying table tabulates the results.

Statistical summary of responses to Case 2

Mean response	\$5316
Median response	\$5000
Standard error	\$571
Z-statistic	3.82
Probability level	0.02

We consider \$7500 important because it is the precise point at which landlords are imposing an equivalent loss on tenants. (Recall that Project A has a net present value of \$1 000 000 and Project B has a net present value of \$250 000. Project A is worth \$750 000 more than Project B. At a relocation fee of \$7500 per tenant, the total cost imposed on tenants is \$750 000). Under *simple fairness*, \$7500 is the bright line by which respondents distinguish between fair and unfair behavior. What these results show is that in this scenario, the majority of respondents went beyond *simple fairness* and embraced *complex fairness*. That is to say, the majority of respondents answered this question in a way consistent with the proposition that one person should not achieve a relatively large gain by imposing a relatively small loss on another. And, in fact, we can be even more precise and restate our findings as follows: Among those respondents who considered fairness as a constraint, they answered in a way consistent with the proposition that one person should not achieve a \$10 gain by imposing a \$7 loss on another (\$5316 divided by \$7500 is approximately 70%).

Before closing this section, we must emphasize that the fact that this case is from the real estate industry is not irrelevant. We do not expect *complex fairness* to hold in every situation where *simple fairness* holds. In fact, the suggestion here has been that the community will demand *complex fairness* only where one party to the transaction is perceived as superior to the other party in some relevant characteristic. To begin to test this we asked student respondents (as part of a follow-up questionnaire) whether or not they agreed with the following statement: “The real estate industry is unique. There is rarely a level playing field for landlords and tenants.” A majority of respondents were more likely to agree with this statement than disagree (statistically significant difference). Not surprisingly, among those respondents who chose Project B in Case 2, this finding was even more dramatic. These results underscore the intuition that *complex fairness* is not a universal phenomenon. In situations where there is little difference between transactors (where there is a level playing field), it is doubtful that *complex fairness* will hold.

Enforcement

If both simple and complex fairness exist as community norms, one wonders how such norms might be enforced, especially in those organizations where the rhetoric of profit maximization is also freely embraced. There are two kinds of enforcement: external and internal constraints.

External constraints consist of the possibility of some kind of retaliatory action on the part of the injured party or parties. For example, tenants may set up a tenants' association and launch a rent strike, threaten a law suit, or plant negative stories about the landlord in the various media. To the extent that reputation and trust are important intangible assets to the landlord such retaliatory action can be a major expense in the long run. Importantly, KKT note that some transactors may even avoid exchanges with offending firms at some positive cost to themselves.

In addition to external constraints, internal constraints may exist, as well. The existence of internal constraints suggests that landlords (and other transactors) may actually have a preference for *simple and complex fairness* rules. By introducing the notion of internal constraints we are purposely opening up the intriguing possibility that some businesses may actually forgo relatively large profits even in the absence of expected future long run costs.²

Practical implications

Although the discussion thus far has been mainly theoretical a number of important practical implications do emerge:

- Whether or not community norms of fairness are viewed as external or internal constraints, those who ignore them do so at their own peril. At minimum, real estate managers need to ask themselves, do we assign any weight to external costs imposed on non-contracting third parties, and if so, how much? Among other things, this implies that managers will have to attempt to estimate tenants' relocation fees, an admittedly difficult job.
- To economists, sunk costs are irrelevant. To the rest of us, sunk costs matter. In the case at hand, the initial cost of \$1 000 000 to buy the complex is probably a relevant fact, even though it is correctly categorized as a sunk cost. Given that we know fairness constraints depend on whether or not a firm is profitable (see discussion above), the larger this number (and therefore the smaller the expected profits are to the real estate company), the less likely it is that the community would expect one to forgo profits.
- Real estate firms, under pressure to forgo relatively large profits, may consider paying relocation fees for tenants and overlooking past rents which have not been paid. In fact, this is fairly common practice in the real estate industry.
- All things being equal, larger and more well-known firms, will need to pay more attention to fairness constraints. As a firm's reputation grows, managers will need to expend more resources protecting it. Growing real estate firms should not be caught off-guard by community standards which were not vigorously enforced when the firm began operations, but are now more carefully scrutinized by the media and other stakeholders.
- Firms might consider treating different types of tenants in different ways. For example, those tenants with especially high relocation costs may be given preferential treatment. Local laws protecting handicapped or elderly tenants may not go far enough. Long term residents with a history of paying their rent on time may be given special consideration when applying income-qualification rules.
- Those real estate firms which believe they are meeting community standards of fairness, may have to actively justify and explain their actions to other stakeholders. Such public relations efforts need to be sensitive not only to legal requirements, but must honestly confront community norms of fairness.

Conclusion

This paper has extended KKT's notion of *simple fairness*. Community standards not only demand that one person should not achieve a gain by simply imposing an *equivalent* loss on another party, but, even further, community standards may demand that one person should not achieve a relatively large gain by imposing a relatively small loss on another party. We label this *complex fairness*.

This paper has demonstrated the existence of *complex fairness* in the real estate industry. And although we do not expect *complex fairness* to hold in every case where *simple fairness* holds, we do not think that there is anything special about the real estate industry except that the community perceives that landlords have an advantage over tenants. We hope to show through future research that similar results obtain in employer and employee relationships and in the area of corporate environmental responsibilities.

Notes

¹ The basic question of this study is to determine whether or not complex fairness exists as a community norm in the real estate industry. To test this proposition cleanly, we want to study to what extent those students who are profit maximizers in the absence of external costs (Case 1) will be egin to factor in costs imposed on third parties (Case 2).

² Here, we are moving beyond what has been called the "commodity-based view" of the business and into the "meaning-based perspective" (Pava, 1997). In the commodity-based view, the business organization is defined as "an instrumental tool to satisfy established wants and preferences." In the meaning-based perspective, the primary characteristic of business is "that it serves as a location where human beings interpret

life." Where the existence of external constraints is consistent with the former definition of business, it seems to us that the existence of internal constraints requires an enlarged view of business akin to the latter definition.

References

- Akerlof, George: 1979, 'The Case Against Conservative Macroeconomics: An Inaugural Lecture', *Economica* **46**, 219–237.
- Kahneman, Daniel, Jack L. Knetsch and Richard Thaler: 1986, 'Fairness as a Constraint on Profit Seeking: Entitlements in the Market', *American Economic Review* **76**, 728–741.
- Okun, Arthur: 1981, *Prices and Quantities: A Macroeconomic Analysis* (The Brookings Institution, Washington).
- Pava, Moses L.: May 1997, 'Corporate Social Responsibilities: Yesterday and Today', paper presented at Symposium in Honor of Clarence Walton, American College, Philadelphia.
- Pava, Moses L. and Joshua Krausz: 1996, 'The Association Between Corporate Social Responsibility and Financial Performance: The Paradox of Social Cost', *The Journal of Business Ethics* **15**, 321–357.
- Solow, Robert: 1980, 'On Theories of Unemployment', *American Economic Review* **70**, 1–11.

Moses L. Pava and Joel Hochman
Sy Syms School of Business,
Yeshiva University,
New York, NY.

Jeremy Pava
Comptroller,
Aspen Square Management,
Springfield, MA.