Negotiating with Your Employee

Salary Negotiations and the Endowment Effect

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Abstract

Manager-employee salary negotiations are a significant part of any organization's activities. The Endowment Effect plays a significant role in the outcome of such negotiations, and understanding its influence is of great importance to organizations and their members. Since the closeness between parties to negotiations was found to minimize the Endowment Effect, we hypothesize that the degree of closeness between employees and managers, as measured by the *leader member exchange* theory (LMX), will also influence the Endowment Effect level. Our findings revealed that an Endowment Effect exists in negotiations in the workplace, where leisure time is exchanged for an increase in salary. However, no correlation was found between the nature of the relationship (high or low LMX) and the Endowment Effect. Apparently, the behavioral norms within a working environment are different than those which exist outside of it. Surprisingly, we find that *age* and *gender* influence the Endowment Effect in salary negotiations.

Introduction

The *Endowment Effect* describes a situation where sellers ask for unreasonable and considerably more compensation to renounce an object which they own, than buyers are willing to reimburse in order to obtain it. This bias implies that people value their own belongings more than they would if they belonged to someone else. Therefore, people have a tendency to demand a higher price for objects they themselves own, than they would be willing to pay for the same objects if they were owned by someone else (Ortona & Scacciati, 1992). Since the Endowment Effect, by inducing high demands, can be a real obstacle when negotiators attempt to reach a settlement, any process that can moderate this effect could lead to positive results (Galin et.al, 2006; Galin, 2009). In the search for such a process, it is the aim of this paper to investigate the impact of the relationship of two negotiators – manager and employee - on the Endowment Effect. In other words, this study examines whether a more informal, close relationship between managers and employees can moderate employees' demands during salary negotiations. In addition, the paper also discusses how age and gender factors influence the Endowment Effect during salary negotiations.

The Endowment Effect has attracted much attention in the literature, due to its implications in a wide variety of fields, such as: economic analysis, decision theory, marketing, consumer behavior, international relations and law. Almost all research projects provide support for the existence of the Endowment Effect (Kahneman & Tversky, 1979; Knetsch & Sinden, 1984; Knetsch, 1989; Kahneman et al., 1990; Kahneman & Knetsch, 1992; Hoorens et al., 1999; Van Boven et al., 2003; Galin et al., 2006; Gimpel, 2007; Galin, 2009).

A *negotiation* is a social interaction during which relationships are formed between the two sides. It is reasonable to assume that the kind of relationship will have an effect on the negotiation itself and, as a result, on the nature of the Endowment Effect. There are two main studies focusing on the nature of the relationship between the two sides in a negotiation, and the influence it has on the Endowment Effect. Halpern (1994, 1997) found that friendly relationships decrease the intensity of the Endowment Effect and lead to a greater rate of agreement between buyer and seller. Mandel (2006) found that the existence of a friendship between buyers and sellers may cancel out or even reverse the Endowment Effect, i.e. the buyer was ready to pay a significantly higher price than the seller would have been inclined to accept.

The nature of the relationship between employees and managers can be examined by characterizing the degree of closeness between the two sides. The *leader member exchange theory* (LMX) (Dansereau et al., 1975; Graen & Uhl-Bien, 1995; Liden et al., 1997) focuses on the dynamic relationship between a *leader* - generally a manager - and a *follower* - generally an employee. The central premise is that a leader develops different kinds of relationships with different followers. LMX theory postulates that the exchange between the leader and the employee can be divided into two basic groups: low-quality LMX and high-quality LMX. In regard to low-quality LMX the leader, in our case the manager, uses legitimate authority and standard organizational incentives, while the subordinate (the employee) performs the work required by the formal contract, agreed upon by both sides (Kim & Organ, 1982). High-quality LMX is characterized by influence, trust, respect and mutual affection (Graen & Schiemann, 1978), where each involved party gives and receives time, effort and support beyond the formal contract (Dansereau et al., 1975, Kim & Organ, 1982). Thus, low-quality LMX can be considered as a formal relationship between a manager and an employee, while high-quality LMX designates a friendly, more informal relationship between the two.

Discussion and Hypotheses

Four main empirical hypotheses were assessed in this research:

1. Salary negotiations between managers and employees induce the Endowment Effect. The employee's salary demands, as a seller, will be greater in return for conceding leisure time than for an increase of identical additional leisure time. An identical salary to concede will be unacceptable to the employee in return for additional leisure time offered by the manager.
2. The higher the LMX, the smaller the Endowment Effect.
3. The older the employee, the higher the Endowment Effect.
4. The Endowment Effect will be higher for men than for women.

Procedure for Collecting Data

The empirical research is based on a questionnaire which includes three parts:

Part 1) In order to measure the Endowment Effect, two theoretical scenarios were included in the questionnaire:

1. The "selling" scenario, in which employees were asked to "sell" 5 hours a week (i.e. to work 5 hours of overtime) of their own leisure time, and propose their required salary increase in return.

2. The "buying" scenario, in which employees were asked to “buy” an additional 5 hours of leisure time a week (by reducing their usual working time) and propose their offer for a salary decrease in return.

The chosen "income vs. leisure time" scenario is based on Ortona and Scacciati (1992).

Part 2) In order to measure the manager–employee relationship, the 14-item LMX scale developed by Ilsev (2003) was included in the questionnaire. Respondents reported on their relationship with their manager by using a five-point Likert scale (1=disagree, 5=strongly agree), measuring formality and closeness of relationship with their mangers. For example, respondents were asked to rate their reaction to phrases, such as: “I have a close working relationship with my supervisor”, “My supervisor treats me as his\her equal”, and “My relationship with my supervisor goes beyond formal roles”.

Part 3) The demographic part of the questionnaire included data regarding age, gender and seniority in the respondents’ workplace.

The study sample was comprised of 119 participants; 41.4% were men and 58.6% were women. The average age was 33.29, with the youngest participant being 20 years of age, and the oldest 64. A total of 41.5% respondents worked in high-tech companies, 19.5% in commerce and services, 11.9% in government organizations, 5.9% in industry, and 21.2% in various other organizations. All 119 participants completed the questionnaire.

To analyze our data statistically, we employed the following methods: Correlations, Regression model, Repeated regression model and ANOVA.

Results

Our findings revealed that an Endowment Effect exists in negotiations in the workplace, where leisure time is exchanged for an increase in salary. Employees, when asked to renounce 5 hours of their weekly leisure time, demanded, on average, a compensation of 12.75% of their current salary. However, when they were offered an additional 5 weekly hours of leisure time, they were ready to accept a salary decrease of only 4.53% of their current salary.

As for the impact of the manager-employee relationship on the Endowment Effect, no correlation was found between the nature of the relationship (high or low LMX) and the Endowment Effect. One possible explanation for this lack of correlation is the supposition that behavioral norms within a working environment are different than those which exist outside of it, and that these differences weaken any effect the relationship might have.

We were surprised to find that *age* influences the Endowment Effect. The Endowment Effect was found to be significantly lower for employees in their 20s and 30s than it was for those aged 40 and above. We believe this surprising finding can be explained by the fact that older employees value their leisure time much more than young employees do.

We also discovered that the correlation between *gender* and the Endowment Effect is not a straightforward one. Women, as compared to men, were ready to renounce a larger part of their salary in return for more leisure time. In contrast, when it comes to selling one's leisure time for a higher salary, no significant correlation between female employees and male employees was found. Apparently, women appreciate their leisure time more than men do; therefore, they are ready to sacrifice a larger part of their salary in order to ‘buy it.

However, when it comes to ‘selling’ leisure time (to compensate for working overtime), no difference was found betweenwomen’s high demands and those of men.

Conclusions and Managerial Implications

The Endowment Effect has a significant influence on salary negotiation between employees and managers. Therefore, managers should be aware of employees’ sensitivity regarding the time they consider to be their “own” - such as leisure time, lunch breaks and vacations. In these cases, managers may expect high, and even unreasonable, salary demands when employees are asked to “sell” these benefits. However, when the situation is reversed, i.e. managers want to add the same benefits (for example, longer work breaks, more vacation days, etc.) and be reimbursed for such additions, they should expect minimal employee’ willingness for reimbursement by salary reductions.

While friendships and informal relationships outside the workplace may moderate, and even reverse, the Endowment Effect, within the workplace both informal and close relationships between managers and employees do not change the intensity of the Endowment Effect. Informal, close relationships do not change the high demand for taken benefits, which employees consider to be their own. Thus, managers should not expect their employees (even if they enjoy a friendly relationship) to ‘understand’ organizational needs and agree to exchange their own benefits for lower compensation.

Furthermore, the older the employee is, the stronger the Endowment Effect. Managers should expect older employees to demand higher reimbursement than younger employees, for any concession they may be asked to make during salary negotiations. Perhaps this is also a negotiation tactic acquired after long experience dealing with manager-employee negotiations.

Moreover, mangers should expect that women, in comparison to men, will tend to make more concessions, during salary negotiations, when it is convenient for them as regards their dual roles as mothers and employees. However, in other cases, women will behave just like men in salary negotiation situations.

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