



## **DETERMINANTS OF NEGOTIATOR'S INITIAL OFFER**

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### Abstract

How do negotiators decide on their initial offer? In a fully crossed 2x2x2 factorial design, 596 managers decided on their initial offer for an industrial building. Knowledge of the opponent's best available alternative ('BATNA') is by far the strongest determinant. Criteria of fairness, as reflected in an estimated market price, are also important. However, awareness of the dependency on the other party has no direct effect on the initial offer.

How do negotiators decide on their initial offer? This extremely simple and straightforward question remains largely unanswered. The absence of an answer is even more surprising when we realize that over the last twenty years decision-making has been put at the heart of the negotiation research agenda (Bazerman, Curhan, Moore, & Valley, 2000; Bies, Lewicki, & Sheppard, 1995; Thompson, Peterson, & Kray, 1995). The question is certainly not trivial. We enter most negotiations with the pressing question: How do we start? What will be our initial offer?

Negotiators clearly see initial offers as part of their definition of the negotiation game. Not surprisingly, most courses and textbooks on negotiation devote entire sessions or chapters on the prescriptive side of the subject (Shell, 1999; Thompson, 1998). (Pruitt & Carnevale, 1993) see a relationship between reservation prices and initial offers: Higher reservation prices lead to higher initial offers. (White & Neale, 1994) state that initial offer is the visible expression of the aspiration level. Research on initial offers has concentrated on the relationship between initial demands and results and has consistently revealed a positive correlation (Benton, Kelley, & Liebling, 1972; Chertkoff & Conley, 1967; Liebert, Smith, Hill, & Kieffer, 1968; Yukl, 1974) 'Firm' negotiators obtain better results (Bartos, 1974; Donohue, 1981; Pruitt et al., 1993; Siegel & Fouraker, 1960). A firm negotiator is defined as a negotiator with high goals, making large initial demands and resisting concessions (Pruitt et al., 1993). Is this large initial demand simply an expression of ambition or a process governed by specific factors?

## THEORY AND HYPOTHESES

For deciding on their initial offer, negotiators certainly use external information, that is information on the bargaining zone (i.e., on both parties' reservation points) and information on market value. They also use such internal information as aspiration values. Negotiators typically carry three 'salient reference points' into a bargaining situation: reservation value, market information and aspiration (Blount, Thomas-Hunt, & Neale, 1996). Those reference points act as anchors (Diekmann, Tenbrunsel, Shah, Schroth, & Bazerman, 1996; Ritov, 1996; Tversky & Kahneman, 1974).

Information of alternatives will strongly influence the decision on reference points (Pinkley, Neale, & Bennett, 1994). Vital information is information about both parties' alternatives, if they do not reach agreement (Raiffa, 1982; Thompson, 1998). Information on alternatives encompasses two different aspects. The first important aspect is the focal negotiator's knowledge of the other party's alternatives. However, there is of course a second aspect, which reflects the mirror question: Has the other party information on the focal negotiator's alternatives? If the answer to that question is 'yes', then the negotiator is fully aware of the interdependent nature of the negotiation. When both parties know the bargaining zone exactly, then the negotiation can take the form of an ultimate bargaining game and will be heavily influenced by norms of fairness (Güth, Schmittberger, &

Schwarze, 1982; Kagel & Roth, 1995; Ochs & Roth, 1989; Pillutla & Murnighan, 1996; Tripp, Sondak, & Bies, 1995).

Market prices can act as focal points in an uncertain environment (White, Valley, Bazerman, Neale, & Peck, 1994) and can also act as an anchor from which buyer and seller will adjust their reference points (Bazerman, 1998). Although there seems to be general agreement on the importance of market prices as reference points, their exact role is far from clear (Blount, Bazerman, & Neale, 1995; Blount et al., 1996; Kristensen & Gärling, 1997). A market value results from negotiations by other parties. When we have negotiated ourselves, our previous purchase price takes the form of a ‘sunk cost’. (Diekmann et al., 1996) clearly showed that buyers, contrary to economic rationality, take sellers’ sunk costs into account when determining their initial offer.

Based on the previous analysis and on ‘salient reference points’, we assume that reservation and aspiration points will act as anchors for initial offers, so that initial offers are positively correlated with reservation and aspiration prices.

We can also assume that the initial offer is also influenced by information on the opponent’s alternatives, by information on the market value, and by a strong awareness of interdependency (i.e., by the fact that each party knows the other party’s available alternatives).

Due to the assumed strong correlation between aspiration prices and initial offer, the three following hypotheses on the effect of the different reference points are net effect, controlling for the effect of aspiration and reservation

*Hypothesis 1: Initial offers are influenced by information on the opponent's BATNA, even when the effect of that information on reservation and aspiration prices is neutralized.*

*Hypothesis 2: Initial offers are influenced by information that the other party knows the focal negotiator's BATNA, even when the effect of that information on aspiration and reservation prices is neutralized*

*Hypothesis 3: Initial offers are influenced by information on the market value, even when the effect of that information on aspiration and reservation prices is neutralized.*

## **METHODS**

### **Design**

When we try to understand how subjects decide on their reservation and aspiration prices and on their initial offers, we have to confront them with decision situations that

clearly differ on relevant dimensions. If under such circumstances we do not find strong effects, we can safely conclude that other variables, such as personality variables or decision-making style, explain the major proportion of the variance in the results. We confronted participants with a decision situation that varied on three dimensions, based on the salient reference points a negotiator uses in negotiation. We used a fully crossed 2x2x2 factorial design with two levels for the three independent variables and, depending on the research question, with reservation and aspiration prices as the covariates.

The study crossed three between-subjects independent variables:

Factor A: (no) information on the opponent's alternative

Factor B: (no) awareness of interdependency

Factor C: (no) information of the market value.

Subjects were placed in a buyer's situation: A businessperson intends to build a repair shop. We deliberately chose an unknown type of building to avoid the strong influence of uncontrollable external market reference points.

Building a new repair shop would cost at least BEF 80 million (approximately USD 2 million).

The businessperson is confronted with an unexpected opportunity to buy an existing building. Adapting this building to his own needs will cost BEF 5 million.

Subjects were asked to determine their reservation price, their aspiration price and their initial offer under eight different conditions resulting from the 2x2x2 design (each subject, of course, was confronted with only one condition):

Factor A: the buyer knows/does not know that the seller has an alternative offer of (only) BEF 25 million.

Factor B: the buyer knows/does not know that the seller knows that the buyer's alternative is to build a new repair shop for BEF 80 million.

Factor C: the buyer knows/does not know that the 'market value' is estimated at BEF 65 million by an independent expert.

When factor A is positive, the decision maker has a complete view of the bargaining zone, which is BEF 25–75 million (appraising the BEF 5 million adapting costs) with a midpoint at 50 Million. When factor B is also positive, the negotiator knows that the other party is also completely informed of the bargaining zone. When factor C is positive, there is unfavorable market information through an external reference point of BEF 65 million.

## **Participants**

Eight different questionnaires were randomly sent to 4,927 alumni of the Vlerick Leuven Gent Management School (Belgium). We received 613 responses (response rate =

12.4%), of which 17 (or 2.78%) were unclear, incomplete on the dependent variables or unreadable. The final analysis is based on 596 subjects of whom 45 (7.6%) are female. The mean age is 40.26 years ( $SD = 9.61$  years). On a 7-point scale (1 = very low, 7 = very high), respondents scored 3.5 on experience in negotiation and 2.8 on formal negotiation training. The eight conditions did not differ statistically on mean age, experience or training.

## RESULTS

The mean and standard deviation of the reservation points, aspiration points and initial offers in each condition are presented in Table 1.

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Insert Table 1 about here

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Contrary to economic theory suggesting that rational negotiators base their reservation points on their available alternatives, reservation points in all conditions are significantly lower than BEF 75 million ( $p < 0.001$ ). The highest mean reservation price (condition 5) is almost 37% higher than the lowest mean reservation price (condition 2). As could have been expected, aspiration points vary even more. The highest mean aspiration point (condition 5) is 84% higher than the lowest (condition 2).

Within conditions, aspiration price and initial offer correlate between .55 (condition 6) and .90 (condition 5). Correlations between reservation price and initial offer are on the average about .30 lower, ranging from .16 (condition 2) to .67 (condition 3).

We learn from Table 1 that means and standard deviations of initial offers vary strongly. If the respondent knows the seller's BATNA (in the even conditions), means and standard deviations are lower than where the seller's BATNA is unknown (in the odd conditions). Hence, knowledge of the other party's alternative drives the initial offer towards that alternative. The effect is impressive. When we compare condition 2 with condition 1, we can see that not informing the negotiator on the other party's BATNA, increases the initial offer by BEF 13.65 million or by 55.4%. The effect on the variance is even more pronounced. The variance in results under condition 2 is 3.51 times smaller than under condition 1. Under condition 1 the 'offer zone' (i.e. the difference between initial offer and aspiration price) is BEF 12.54 million, while under condition 2, the offer zone is reduced to almost half (BEF 6.99 million).

Our central research question deals with decisions on initial offers. In order to examine how reservation and aspiration values shape the initial offer, we performed eight different regression analyses with initial offer as dependent and reservation and aspiration price as independent variables (see Table 2).

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Insert Table 2 about here

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One result is very striking, in that the odd conditions attain extremely high levels for  $R^2$ . Those are the conditions where the buyer does not know the seller's BATNA. Under those circumstances, initial offer is very highly correlated with aspiration level.

As can be seen from Table 2, t-values for reservation point are always negative: there is a negative partial correlation between initial offer and reservation point. Given a certain level of ambition or aspiration, the higher (i.e. more unfavorable) the buyer's perception of the reservation price, the lower his or her initial offer. A negotiator wants to create a certain distance between aspiration price and initial offer. A negative partial correlation simply means: the greater the distance between aspiration price and reservation price (the so-called aspiration zone), the greater the distance between aspiration price and initial offer (the offer zone). Significance of this partial negative correlation is reached under conditions 1, 3, 4 and 7. Marginal significance is obtained under conditions 5 and 6. This phenomenon can be clearly illustrated by the correlation between aspiration zone and offer zone. It is the strongest in conditions 1 and 7, approaches zero in conditions 2 and 6 and is even slightly negative in condition 8. The pattern is very clear: the less relevant the information, the bigger the correlation. The definition of relevant information is therefore obvious: vital information is information about the other party's alternatives. As can be seen from Table 3, the negative partial correlation emerges when the buyer does not know the seller's BATNA (Three times

highly significant and once marginally significant). This of course is the most common bargaining situation.

Can we be more precise on the matter? How important are the different factors in determining the initial offer? In order to answer these questions, we performed a variance analysis with three fixed factors. As we have seen from Table 2, variances vary strongly over conditions. In such cases, it is strongly recommended to work with equal cell sizes. Therefore, we limited each condition to 68, by using the first 68 respondents per cell. (We did not find any significant difference between the total sample and this sub-sample; the average age, for example, of the sub-sample is 40.24 years compared to 40.26 years for the total sample).

Results of a three factor ANOVA with initial offer as the dependent variable and aspiration and reservation point as covariates can be found in table 3

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Insert Table 3 about here

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Hypothesis 1 is clearly supported: ‘knowledge of alternatives’ (factor A) is very significant ( $F = 23.67$ ;  $p. < 0.001$ ). Hypothesis 2 is not supported: ‘interdependency’ (factor B) is not significant, not as a main effect, nor in an interaction role. Hypothesis 3 is also supported: market value (factor C) is very significant ( $F = 10.45$ ;  $p. = 001$ ).

Compared to the main effects the A\*C interaction effect is very strong ( $F = 28.18$ ;  $p. < 0.001$ ): the role of information on market value only plays when there is no information on the BATNA.

Knowing the other party's BATNA (factor A) has a dramatic effect: the mean initial offer of the four conditions with information of the opponent's BATNA is BEF 26.90 million, and the mean of the four conditions without this information is BEF 44.16 million. Not knowing the seller's BATNA increases the buyer's initial offer by BEF 17 million or 64%. However, the majority of the 'BATNA'-effect is caused by indirect effects, esp. through the 'BATNA'-effect on aspiration. The net 'BATNA' effect is BEF 3.36 million.

Knowledge of market value (Factor C) leads to an average initial offer of BEF 36.48 million, compared to BEF 34.58 million when the focal negotiator does not know the market value. This difference of about BEF 2 million is certainly not negligible, but pales in comparison to the 'BATNA'-effect of more than BEF 17 million. Relatively however, the net effect of knowledge of marketing value is very strong: BEF 1.73 million. An initial offer is more public, and may be more restraint by fairness than aspiration, which is more private.

## DISCUSSION

Our central research question deals with deciding on initial offers. In the process of studying this question, we examined three salient reference points: reservation price, aspiration price and market value (Blount et al., 1996). We have focused on the negotiator's mental model of a typical two-party distributive negotiation. How do negotiators construct the negotiation problem in terms of market value, reservation point, aspiration points and initial offers?

Our study demonstrates that in deciding on their initial offer, negotiators are chiefly influenced by information on the other party's BATNA. (Pfeffer, 1992) identified interdependency as a strict condition for conflict. (Kahn, 1991) asserts that interdependency is the most central element of a negotiation process. Both parties partially control outcomes valued by the other party. Negotiation is the management of interdependency. Recent negotiation literature has focused on how negotiators define the game (Bazerman et al., 2000). Experienced managers clearly define the negotiation situation in terms of interdependency. However, their evaluation of interdependency is one-sided.

Negotiators assess their relative power and set their own reference points accordingly. In this process they show a remarkably consistent approach: once they know the other party's alternative, they forget about their own 'best alternative to a negotiated

agreement' and focus on the other party's 'best alternative to a negotiated agreement', rationally applying negotiation analysis prescriptions... to the other party. Their behavior confirms the widely accepted view that 'the most valuable information is knowing our opponent's best alternative' (Thompson, 1998). 'Negotiating rationally' in practice means: tell me where your BATNA lies and I will go for it. This behavior is only very moderately softened by our awareness of the fact that we also depend on the other party.

While deciding on their initial offer, negotiators are also influenced by market value, but much more strongly when they do not know the 'real thing', namely the other party's alternative. The rather restricted influence of 'market value' can be understood by the distinction made by (Blount et al., 1996), who convincingly showed that some types of market information are more influential than others: under perception of high variance, market information will be less influential. In our experimental manipulation, subjects were confronted with an expert assessment. This might have led to the perception of high variance, enforced by the 'single' nature of the value. There are not many repair shops for sale.

Demonstrating an almost unbelievable lack of empathy, negotiators are only slightly influenced by the symmetrical information that the other party knows what they have to know, namely my BATNA. This factor plays an almost non-existent role in deciding on initial offers (given reservation and aspiration points). Negotiators are greedy, as can be learned from 'the ultimate bargaining' situation in condition 4. Fairness will

restrain them from being too greedy. However, fairness is often defined in an egocentric way (Thompson & Loewenstein, 1992). Our results show how extremely egocentric even experienced managers are: they claim up to 90% of a commonly known bargaining zone.

Reference points influence negotiators. What do we do when we lack external reference points? We start looking at our own situation. We observe our own reservation price and start interfering with the other reference points from this only certainty in a very uncertain world. A psychological bootstrapping process starts, leading with a constant aspiration point to a statistical negative partial correlation between initial offer and reservation price. This bootstrapping almost completely disappears when negotiators know what they have to know, i.e., the other party's BATNA. This phenomenon is illustrated by the correlation between aspiration zone and offer zone. The less relevant the information we have, the higher the correlation, and the more bootstrapping.

Due to the negative partial correlation and given a certain aspiration, the weaker my reservation price is, the more aggressive my initial bid will be. With no information on the other party's alternatives, extreme initial offers represent a case of 'whistling in the dark'.

The significant main effect for 'information of market value' and the interaction effect with 'information of the other party's BATNA' is very instructive: negotiators clearly look at market values, sunk cost or similar reference points. But 'vae victis' (woe

to the vanquished): as soon as the negotiator knows ‘the real thing’, market values become marginally relevant. In terms of a linear programming model, one could say: managing the interdependency is the goal variable, or the objective, and other variables are merely constraints. There is a large and still growing literature on norms in negotiation. Procedural justice and distributive justice are important, but in our analogy with operations research, they represent the constraints. Market value and sunk costs clearly belong to the world of ‘fair prices’: they set (moral) constraints. Market values only seem to play a role when they represent a morally binding ‘fair value’. This seems not to be the case for carousel horses, for students or for repair shops for businesspersons. They are more influential in stereo-installations or condominiums for students.

The global picture becomes clear: negotiators are fully aware that negotiation is the management of interdependency. They look at the bargaining zone. When that view is clear, when they know the other party’s alternative, they understand ‘the rules of the game’, and they start negotiating in the neighborhood of that alternative. When they do not know that alternative, they look at other reference points such as market value. When there is almost no relevant information, they turn inwardly and focus on their own situation. Knowing the other party’s alternatives is by far the best guarantee to take the ‘big view’ on the bargaining zone, to develop a large scope. The second way to a large scope is to be ambitious, to set high goals. The third way is not to be influenced by unfavorable market information. Finally, not realizing that the other party might have information on your alternatives will also help to keep ‘the big view’. However, bigger is

not of course always better. If under the influence of the last three factors negotiators have become too greedy, chances are high that they do not reach any agreement at all (Pruitt et al., 1993). Negotiation, after all, is the management of interdependency.

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**TABLE 1**  
**Means and Standard Deviations by Condition (N = 596)**

#	Factor			n	Reservation price		Aspiration price		Initial offer	
	A <sup>a</sup>	B <sup>b</sup>	C <sup>c</sup>		M	SD	M	SD	M	SD
1	N	N	N	72	65.21	17.60	50.54	12.98	38.00	13.01
2	Y	N	N	72	51.00	18.64	31.64	8.23	24.65	6.94
3	N	Y	N	83	65.64	15.08	52.97	15.37	41.77	16.13
4	Y	Y	N	86	53.67	16.94	35.50	9.15	26.86	5.60
5	N	N	Y	73	69.62	12.94	58.33	9.58	49.20	10.20
6	Y	N	Y	71	54.74	15.11	36.58	10.07	26.39	5.72
7	N	Y	Y	71	66.21	11.33	56.57	10.16	47.56	10.29
8	Y	Y	Y	68	59.13	13.17	40.87	11.44	29.82	9.20

<sup>a</sup>A: The other party's BATNA is (not) known

<sup>b</sup>B: That the other party knows my BATNA is (not) known - ('interdependency')

<sup>c</sup>C: Market value is (not) known

**TABLE 2**

**Summary Regression Analyses under Eight Different Conditions**

cond.	df	R <sup>2</sup>	t <sub>reservation</sub>	p	t <sub>aspiration</sub>	p
1	71	.73	-3.03**	.00	10.53***	.00
2	71	.51	-.36	.72	7.40***	.00
3	82	.79	-2.47*	.02	11.26***	.00
4	85	.47	-3.38**	.00	8.90***	.00
5	72	.81	-1.60	.11	11.84***	.00
6	70	.34	-1.73	.09	5.62***	.00
7	70	.82	-4.05***	.00	12.10***	.00
8	67	.63	-.80	.43	9.44***	.00

\*p < .05

\*\*p < .01

\*\*\*p < .001

**TABLE 3****Tests of Between-Subjects Effects with initial offer as dependent variable**

Source	Sum of Squares	d	Mean Square	F	Sig.
Corrected Model	81329.01	9	9036.56	249.46***	.00
Intercept	494.06	1	494.06	13.64***	.00
RESERVATION PRICE	708.13	1	708.13	19.54***	.00
ASPIRATION PRICE	23003.02	1	23003.02	635.00***	.00
FACTORA	857.10	1	857.10	23.66***	.00
FACTORB	1.28	1	1.28	.04***	.85
FACTORC	378.70	1	378.70	10.45**	.00
FACTORA * FACTORB	24.60	1	24.60	.68	.41
FACTORA * FACTORC	1020.75	1	1020.75	28.18***	.00
FACTORB * FACTORC	1.76	1	1.76	.05	.83
FACTORA * FACTORB * FACTORC	62.57	1	62.57	1.73	.19
Error	19344.18	534	36.23		
Total	787492.25	544			
Corrected Total	100673.19	543			

\*\*p &lt; .01

\*\*\*p &lt; .001

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Dirk Van Poucke is professor at the Vlerick Leuven Gent Management School and a practicing lawyer. His Ph.D. in applied economics is from Ghent University. His research interests are negotiation analysis, with particular emphasis on understanding the deviation of actual practice from normative theory and identifying leverages for more effective negotiaton.

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