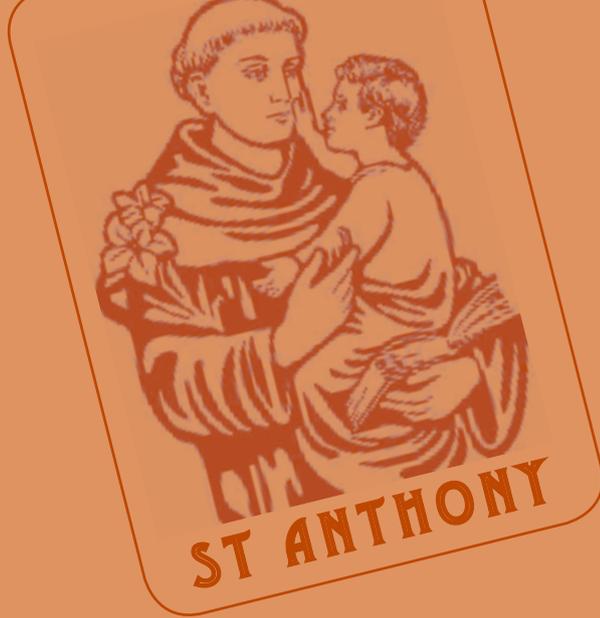


# IT'S MINE

WE HATE LOSSES



I was a child of the 1960's and 70's and, from day one, we were schooled in the art of using less – partly because we never had much money, but also because of the times and my parents' environmental beliefs. I never knew not to turn the lights off, or to let the hot (or cold for that matter) tap running. The car was for functional trips only - where possible we cycled. Surprising though it may be today, I have never lived in a house with a clothes drier or a dish-washing machine. So when someone asked me recently how I can possibly live without them, I was bemused - *sure it's easy*, was all I could say. She said that there was no way that she could ever give hers up.

Messages about climate change or oil depletion are often accompanied by recommendations that we cut back, or cut out high energy activities, driving, flying or indiscriminate shopping. But what has to be remembered is that most of us dislike sacrifice and we hate losses.

Roughly speaking, losing something makes us twice as miserable as gaining the same thing makes us happy. Therefore, losses have more than twice the psychological impact as equivalent gains.

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## THE ENDOWMENT EFFECT

The endowment effect is a term coined in 1980 by US behavioral economist, Richard Thaler, to describe the hypothesis that people value something more, once their property right to it has been established. In other words, people place a higher value on objects they own relative to objects they do not.

The effect kicks in when something is given to you - it is now yours. Ownership creates satisfaction. After only a few minutes, giving it up will entail a loss.

In an experiment by Kahneman, Knetsch and Thaler<sup>1</sup> half the students in a class were given coffee mugs with the insignia of their home university embossed on it. The students who did not get a mug were asked to examine their neighbour's mugs. The mug owners were then invited to sell their mugs, and the non-owners were asked to buy them. Each had to answer the question "at each of the following prices, indicate whether you would be willing to give up your mug/buy a mug." The results showed that those

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<sup>1</sup> Richard Thaler & Cass Sunstein (2008); *Nudge*; p. 33

with mugs demanded roughly twice as much to give up their mugs as others were willing to pay to get one. Thousands of mugs have been used in dozens of replications of this experiment, but the results are nearly always the same. Once I have a mug I don't want to give it up. But if I don't have one, I don't feel such an urgent need to buy one. In another experiment, half the students were given coffee mugs and the other half got chocolate bars. The mugs and the chocolate cost the same, and in pre-tests students were as likely to choose one as the other. Yet, when they were offered the chance to switch from a mug to a bar of chocolate, or vice versa, only one in ten switched!

Interestingly, when it is explained to subjects that their behaviour is "irrational", they tend to strongly disagree. They are not making simple mistakes, which when pointed out, they instantly correct. People will gladly defend their instinct to value what is already theirs.

Another study<sup>2</sup> compared the way in which the endowment effect influences people to make car-buying decisions, under two conditions. In one, they were offered the car loaded with options, and their task was to eliminate the options they didn't want. In the second, they were offered the car devoid of options, and their task was to add the ones they wanted. People in the first condition ended up with many more options than people in the second. Because losses hurt more than gains satisfy, people judging, say, a \$400 stereo upgrade that is part of the car's endowment may decide that giving it up (a loss) will hurt more than its \$400 price. In contrast, when the upgrade is not part of the car's endowment, they may decide that choosing it (a gain) won't produce \$400 worth of good feeling. So the endowment effect is operating even before people actually close the deal on their new car.

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## LOSS AVERSION

Loss aversion has been proposed as an explanation for the endowment effect - people are more motivated by avoiding a loss than acquiring a similar gain. This, of course, affects how we make decisions in risky situations.

Psychologists, Daniel Kahneman and Amos Tversky, worked together to develop Prospect Theory, which aims to explain irrational economic choices and is considered one of the seminal works of behavioural economics. In 2002, after Tversky's death, Kahneman was subsequently awarded the Nobel Prize in economics science.

Consider the question: *would you bet €10 on the flip of a coin if you stood to win €20?* You've got a 50% chance of losing €10 and a 50% chance of winning €20, which seems like a good bet to take. Yet studies show that people tend not to take it.

Before Kahneman and Tversky (1979) published their research, risky decisions were usually analysed by thinking about the total wealth involved. When you look at the bet in this context it makes sense to gamble - it's obvious you've got more to gain than you have to lose - but most people keep their hands in their pockets.

Kahneman and Tversky have shown that in fact people think about small gambles in terms of losses, gains and neutral outcomes. It is actually the changes in wealth on which people base their decision-making calculations. It also turns out that at low levels of risk, such as this coin flip situation, people are more averse to the loss of €10 than they are attracted by the chance of winning the €20. Studies have shown

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<sup>2</sup> Barry Schwartz (2004); *The Paradox of Choice*; p. 72

that people actually need the chance of winning €30 before they'll consider risking their own €10. Now imagine the following two options: you have an 85% chance of losing €1,000 along with a 15% chance of losing nothing, or you have a 100% chance of losing €800. According to logic you should choose the sure loss of €800, but most people don't. When the potential for loss is there, suddenly, people prefer to gamble and take a risk. Yet, when there's the potential for gains, people are more risk averse.

Following on from this, Kahneman and Tversky realized that people behave in different ways depending on how the risky situation is framed and whether the risk is presented in terms of losses or gains. They posed the following classic examples.

*Imagine your country is preparing for the outbreak of a disease expected to kill 600 people. If program A is adopted, exactly 200 people will be saved. If program B is adopted there is a 1/3 probability that 600 people will be saved and a 2/3 probability that no people will be saved.*

Because the risk is presented in terms of gains, 72% of people chose option A which is, in fact, worse!

*Imagine your country is preparing for the outbreak of a disease expected to kill 600 people. If program A is adopted, exactly 400 people will die. If program B is adopted there is a 1/3 probability that no one will die and a 2/3 probability that 600 people will die.*

This time the same problem is presented in terms of losses. Now 78% of people choose B – they suddenly prefer to take a risk, despite the fact that both situations are, mathematically, identical.

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## STATUS QUO BIAS

Status quo bias - a term coined by William Samuelson and Richard Zeckhauser (1988), is also connected to loss aversion - it is assumed that the loss of the status quo option looms larger than the gain of an alternative option. As a general rule, people are conservative because they do not want to lose the gains they have already made. As a result, they may view attempts to get ahead as potentially risky. In several studies, when presented with basically identical situations, subjects tend to choose the decision which is least likely to cause a loss.

This cognitive bias obviously plays a very important role in decision making, causing people to make the choice which is least likely to cause a change. The status quo bias can also play a role in daily routines; many people eat the same thing for breakfast day after day, sit in the same seat in class, or walk to work in exactly the same pattern, without variation. The inability to be flexible can cause people to become stressed or upset when a situation forces them to make a choice, and it may close their eyes to potential opportunities.

While loss aversion operates as a kind of cognitive nudge pushing us not to make changes, even when they are in our interest, it is not the only reason for inaction.

Another cause can be lack of attention or lethargy – we adopt the “yeah whatever” heuristic. For instance, a surprising number of us don't switch TV or radio channels. Despite many other available choices, we keep watching or listening to the one we're on. We fall victim to the automatic renewal of magazine subscriptions. Those in charge of circulation know that if people have to make a phone call to cancel the likelihood of renewal is much higher than if we have to do something to indicate that we actually want to continue receiving the magazine.

In an experiment carried out by Brian Wansink,<sup>3</sup> patrons of a Chicago cinema were given a free bucket of stale popcorn (popped 5 days earlier, so that it actually squeaked when eaten!). People were not specifically informed of its staleness, but they didn't like the popcorn. As one person said *"It was like eating Styrofoam packing peanuts"*. Half of the moviegoers received a big bucket of popcorn and half received a medium-sized bucket. On average, recipients of the big bucket ate about 53% more popcorn, even though they didn't really like it. When asked if they might have eaten more because of the size of their bucket, most denied the possibility, *"Things like that don't trick me."*

In another experiment, people sat down to a large bowl of Campbell's tomato soup and were told to eat as much as they wanted. Unbeknownst to them, the soup bowls were designed to refill themselves (with empty bottoms connected to machinery beneath the table). No matter how much soup subjects ate, the bowl never emptied. Many people just kept eating, not paying attention to the fact that they were really eating a great deal of soup, until the experiment was (mercifully) ended. Large plates and large packages mean more eating. It plays its part when people are asked to switch to low carbon activities.

In economics, the status quo bias explains why many people make very conservative financial choices, such as keeping their deposits at one bank even when they are offered a better rate of interest by a bank which is essentially identical in all other respects. The status quo bias can also play a role in the world of marketing, as companies have learned to their chagrin when they radically redesign packaging or ingredients of popular products. While the status quo bias can provide a certain amount of self-protection by encouraging people to make safer choices, it can also become crippling, by preventing someone from making more adventurous choices. Like other cognitive biases, this bias can be so subtle that people aren't aware of it, making it hard to break out of set patterns. It plays its part when people are asked to switch to low carbon activities.

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## SUNK COSTS

Humans have a psychological need to persevere and succeed even if there appear to be insurmountable obstacles. And the more time, effort and money you invest in the endeavour, the harder it is to pull out of it, even if it becomes obvious that the outcome will not be good. While it may appear to the objective observer that there is no point in throwing good money after bad, that is often just what we do because we are not able to respond rationally. We want to see our efforts pay off, and the more we have invested the more we want results. And we believe that if we work hard there should be some reward. Before we know it, we have reached the point of no return.

In a paper by Hal R. Arkes and Peter Ayton,<sup>4</sup> the authors say that there is no evidence that lower animals or young children exhibit this behaviour. They contend that a major contributor to the sunk cost effect is people's desire not to appear wasteful. They quote the following experiment:<sup>5</sup>

*Assume that you have spent \$100 on a ticket for a weekend ski trip to Michigan. Several weeks later you buy a \$50 ticket for a weekend ski trip to Wisconsin. You think you will enjoy the Wisconsin ski trip more than the Michigan ski trip. As you are putting your just purchased Wisconsin ski trip ticket in your wallet you notice that the Michigan ski trip and the Wisconsin ski trip are for the same weekend.*

*It's too late to sell either ticket, and you cannot return either one. You must use one ticket and not the other. Which ski trip will you go on?*

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<sup>3</sup> Richard Thaler & Cass Sunstein (2008); *Nudge*; p. 43-4

<sup>4</sup> <http://americandreamcoalition-org.adblog.org/transit/sunkcosteffect.pdf>

<sup>5</sup> Arkes and Blumer (1985)

Over half of the participants who were asked this question said that they would rather go on the ski trip they would enjoy less - the Michigan trip! This is contrary to the maxim that one should decide on the basis of incremental costs and benefits. Apparently, many participants thought that they should go on the less desirable trip because to go on the less expensive Wisconsin trip would “waste” twice as much money.

Arkes and Ayton also refer to Tversky and Kahneman’s (1981) “lost ticket scenario.”

*Imagine that you have decided to see a play where admission is \$10 per ticket. As you enter the theatre you discover that you have lost a \$10 bill. Would you still pay \$10 for a ticket for the play?*

88% of the participants said they would. 12% said they wouldn’t.

*Now imagine that you have decided to see a play and paid the admission price of \$10 per ticket. As you enter the theatre you discover that you have lost the ticket. The seat was not marked and the ticket cannot be recovered. Would you pay \$10 for another ticket?*

This time, just 46% of the participants said they would and 54% said they wouldn’t!

So, if we lose the money, we are likely to buy another ticket because we don’t see the two amounts as being linked. However, if the money had already been assigned to the ticket, we cannot separate this prior loss from the current decision about whether or not to spend another \$10. As a result, the ticket seems too costly (\$20), and it is less likely to be purchased.

You can see why it’s so hard for people to give up their gas guzzling SUV...

