POLICY MAKING, ECONOMIC RESEARCH AND LOSS AVERSION: THE SAD CASE OF PENSION REFORMS

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In mainstream economics, utility is symmetrical. So in absolute terms the impact of gaining 100 euro vs. that of losing 100 euro is the same in absolute terms (the only thing that changes is the sign, from positive to negative.) So if at 9.30 am you find a 100 euro banknote in the street and lose it after five minutes, at 9.40 am you should be as happy as you were at 9.20 am. I am afraid that this is not case for most of us.

This is why one of the most important concepts introduced by behavioural economic research has been that of loss aversion. To be exact, behavioural economics re-discovered loss aversion as in "The theory of moral sentiments" (1759) Adam Smith commented that "*we suffer more . . . when we fall from a better to a worse situation, than we ever enjoy when we rise from a worse to a better*." That's pure loss aversion!

Loss aversion is associated with the fact that the pain of losing is psychologically much bigger (typically, at least twice) than the pleasure deriving from an equivalent gain. The existence of loss aversion explains why people are more willing to take risks to avoid a loss than they would be to achieve a gain. Loss aversion has also been used to explain the endowment effect (if you own something, you would not sell it at a price which is not higher than the one you paid) the sunk costs fallacy (if we've spent resources on something we're inclined to stay the course so as not to waste what we've already spent. In other words, we want to avoid feeling the loss of what's been spent, so we stick with our plan, hoping for a gain, even when sometimes that just leads to a bigger loss in the long run) and the status quo bias, explained at a later juncture.

And loss aversion has a significant impact on many choices we make daily, including very personal ones. How many couples carry on with their stagnant ménage just because they fear the loss of a historical relationship, irrespective of the gains that could come from moving forward?

So it is not surprising that loss aversion also features in the way in which economic researchers and policy makers communicate (or don't communicate) with each other. Before examining the specific issue of welfare reforms, let's have a look at the general case.

For economists, loss aversion is a main determinant in at least three behavioural traits:

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The first one has to do with status. Many economists believe that they belong to an enlightened, somewhat superior, community, defined by precise behaviour rules. This is why they, who are typically very protective of their theoretical set-ups, often find it vaguely insulting if someone should remind them that practical results are more important. Accepting the reality challenge would in a way imply a loss of status.

The second one relates to the need of respecting the community's unwritten rules when writing research. One such rule requires that before you draw your own conclusions on a topic, you need to show how those conclusions stand with respect to existing research. Assume you are writing a policy paper on fiscal policy effectiveness: irrespective of whether you suggest that fiscal policy is effective or not, you can't really skip a preliminary survey of the merits and/or the limits of existing research on Ricardian equivalence. Only after you do that, you are entitled to present your own views on the matter. If you don't follow this pattern, it is likely that you would be accused of being superficial by fellow academics, which amounts to reputation loss.

And there may be a third reason why economic papers are written in a stilted and intimidating way. It has to do with the question of incentives (or rather the absence of incentives) to establish working communications with policy-makers. On top of the above career-linked considerations, would researchers really like their policy prescriptions to be translated into actual policy schemes? The answer to this question is not as simple as it may look.

Assume that as an economist I have just written a paper containing an innovative proposal to boost output via selective cuts in public spending. Of course the validity of the proposal is conditional on a number of factors, including, for example, the timeliness of cuts, the invariance of the external macroeconomic environment, the minimum size of the intervention, and many others. What is the likelihood that if a policy-maker picks up my proposal and tries to implement it, all the necessary pre-conditions are met?

Chances are that cuts are timely but the environment is wrong, or the environment is right but action is too timid, or cuts are not done in the right areas. Overall, the probability that my name is associated with a policy flop is non-negligible. And I don’t want that , so, as a kind of insurance policy against possible reputation losses, I will continue to produce highly articulated papers so full of distinctions and caveats that they (safely) verge on obscurity.

Overall, the impact of loss aversion on the way in which economic research is conducted therefore contributes to create a product that obeys rigid design standards and is often deliberately set up in a user-unfriendly way.

So much for economists. Let's now turn to policy-makers and their attitude towards research. Are they unhappy with the inward and uncommunicative nature of most economic research?

In normal situations, they are not. When things go well, no emergencies are there and electoral and/or career perspectives look good, loss aversion is at its highest, and generates one of the most common behavioural distortions: the *status quo* bias . The s*tatus quo* bias is evident when people have an *a priori* preference for things to stay the same by doing nothing or for sticking with a decision made previously (Samuelson, & Zeckhauser, 1988), especially when it is important to avoid regret. People feel greater regret for bad outcomes that result from new actions taken than for bad consequences that are the consequence of inaction (Kahneman & Tversky, 1982). This explains why an experienced politician with good prospects is reluctant to embark on risky innovative policy reforms. And, just in order to avoid temptations, the less readable the research papers, the better.

Overall, it is thus loss aversion, on the part of both the policy-makers and the researchers, which structurally dwarfs both demand and supply incentives for more effective communication channels.

In particular, in normal political situations, policymakers' demand for research is weak. There can be however circumstances in which weakness is more on the supply side. As a matter of fact, robust incentives can exist in highly charged political contexts, such as elections. In such situations, especially when the incumbent is considered to be the front-runner, challengers may have an incentive to lay it all on the line. And it's loss aversion again as challengers are willing to take risks to avoid a likely loss. So they try to boost their image via the incorporation in their political platform of refreshing if controversial policy schemes – remember President Reagan and the Laffer curve? The same is valid for pathological situations. Take the case of pensions, and in particular public expenditure for pensions. Wherever such expenditure goes beyond reasonable levels , politicians would express noticeable demand for smart ideas, even if encapsulated in obscure and reader-unfriendly research. But it takes two to tango. How about supply?

Each year, hundreds of thousands of economic research papers are produced. For example ,Google Scholar would tell you that 165,000 papers about economic growth have been written since 2016. Talking of policies, in the same period a good deal of research has been devoted to monetary policy (72,000) and fiscal policy (50,000). As to sectoral fiscal reforms, 46,000 papers focussed on tax reform, but only 20,000 on pension reform. Why so little? Is pension reform less important? Actually, the weight of pension expenditure over GDP varies widely across countries. It is less than 5 % in the US, about 7% in the UK and approximately 10% in Germany. France and Italy (with 14% and 15% , respectively) are the only G7 countries in which pension expenditure is completely out of line. In all countries, however, the share of pensions to GDP is projected to remain almost

unchanged in the next 30 years. In terms of dynamics, other sectors are much hotter. In major industrial countries, for example , healthcare-related public expenditure rose in the last 10 years from about 6% to 8% of GDP (may be this is why over the same period research papers on healthcare reforms averaged approximately 42,000 per year).

The conclusion is that, in a research world dominated by trends prevailing in its Anglo-Saxon component, pension reform seems to be the lowest of the low, as it is almost a "local" issue, more than a global one. And a loss averse economist aiming at getting big in the international arena would therefore be reluctant to conduct research on it. The implication for policy makers in France, and especially Italy (where high pension expenditure interacts perversely with a monster public debt) is that they cannot lean on international research to find solutions. They have got to take their destiny in their own hands and come up with ideas of their own on possible reforms if they want pension expenditure to go back to more acceptable levels.

References

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