

Can behavioural Economics Improve the Understanding of Politics?*

by

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Abstract: The classic public choice theory has been very important explaining various political phenomena. Incorporating insights from behavioural economics, could improve the analysis of the shape and function of political institutions. Even if institutions are fundamental in the analysis of policy making they are often taken as given. Phenomena from behavioural economics such as self serving biases, loss aversion, encompassing sentiment coordination, status quo bias, endowment effect and framing can however provide an explanation for the shape of institutions. A common result of these phenomena on policy is path dependence which is consistent with institutional theory. In this paper, the foundations of such a behavioural model are outlined and some areas in the domain of tax and welfare policy where the model can be applied are suggested.

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1. Introduction

The classical public-choice theory¹ has contributed much to improving the understanding of the political process. It has described how, for example, bureaucrats or politicians gain from the government growing in size, and it describes how *rent seeking* can be the driving force behind the legislative process (Buchanan & Tullock 1962, Tullock 1965, Stigler 1971, Peltzman 1976, Tullock, Seldon & Brady 2004, Niskanen 1971). Recent advances in behavioural economics can however add a dimension to the analysis, especially when it comes to the understanding of how the voters' demand for certain policies shapes institutions. Institutions have been part of economic historic analysis ever since the seminal work of Veblen but the question why institutions look the way they do is often neglected and deserves more attention.

The last three decades, a growing number of studies have explored how economic actors are constrained by bounded rationality. How people act under bounded rationality has been thoroughly when it comes to behaviour on the financial markets and many of the finding can be applied to other areas as well. (Ellsberg 1961, Knetch 1992, Loewenstein & Elster, 1993, Loewenstein, et al 1999, Odean 1998, Rabin 2000, Shafir et al 1997, Thaler 1980, 1993, 1994, Strarmer 2000).

The ability to make fast decisions using rules of thumb - heuristics – does not need to a defect but can be a skill of evolutionary value. (Dawkins 1989). During the major part of the history of man, when we lived as hunters and gatherers, the ability to make

¹It can be discussed whether the expanded theory where public choice is complemented with behavioural economic insights should be seen as a part of the public-choice theory or as a stand-alone theory. This philosophical question about the hierarchy of sciences falls outside the scope of this paper, and I will therefore use the term public choice – or classical public choice – as something that that is separate from the theory that I describe in this paper. If we use Tullocks (2004) definition”the application of economic theory on non-economic areas” my analysis however is definitely part of the field of public choice. The most widely used version of public choice is however based on neo-classical assumptions and do not incorporate behavioural effects. This “classic” public choice falls clearly outside my field.

decisions with limited information by using simple rules of thought was likely to be a skill that increased the chances of survival². Because of this, we can expect that humans have a drive to use heuristics in today's modern society as well. Both empirics and data from experiments indicate that this is the case. (Cramerer et al 2004, Schkade & Johnson 1989, Kahneman & Frederick 2002, Kahneman & Tversky 1979, 1984, Knetsch 1989, Loewenstein & Adler 1995). It is reasonable to assume that these effects could be applied to politics and the study of political institutions and such an overview is provided in this paper.

The paper is structured as follows. Section 2 provides a general example how classic public choice could be supplemented by behavioural insights for enhanced understanding. Section 3 explores why we might encounter areas where we have significant disagreement between politicians (agents) and voters (principals). Section 4 looks into the rhetoric of kin and their/ its effects on policy. Section 5 deals with some of the most used behavioural economic regularities, reference points, status quo biases and ratchet effects and their implications on policy. Section 6 deals with the specific effects on welfare policy and finally section 7 with path dependence, a result of many behavioural regularities.

2. Public choice and behavioural economics

That rent seeking politicians must adapt to the wishes of the electorate are a straightforward assumption. In a democracy, it is the voters who make the final decision about the policies. If there is a widespread public resistance against the current policies, the elected officials are voted out of power. Therefore, it is a reasonable assumption that the demand for certain political solutions to some extent determine which policies that are realized.

²Those who met a sabre-toothed tiger during their hunt had to make a quick decision, flee or fight? Those who searched for further information or tried to do more advanced risk calculations would quickly be eaten, and their genes would come to an evolutionary dead end.

One reason that countries such as Sweden and Norway have extensive public welfare systems while countries like Switzerland, the US and Japan have low taxes and a high degree of private responsibility for welfare services could, after all, be that the electorates have different preferences. (Alesina, Glaser & Sacerdote 2001).

In many instances, it is not rational for the voter to spend much time on evaluating the political alternatives. The probability that one's vote will affect the outcome of an election is very slim, and it is therefore not rational to study the political programs in detail or to evaluate what various possible majority coalitions imply. To vote for the same alternative as in the last election, or to vote for the same alternative as your father, can often be a working rule of thumb. However, you can easily observe that people around you have considerably greater knowledge about politics than Downs' (1957) model on rational ignorance would indicate. People also vote to a greater extent than predicted by the theory. However, we don't rule out that rule of thumb is an appropriate and widely used model for making decisions.

It is reasonable to assume that the same degree of rationality, or lack of rationality, guides you whether we trade financial instruments or act as voters and office holders. We do not become a new type of human beings when we enter the voting booth or enter into the parliament building.

Another basic assumption in economics is that only revealed preferences are valid (Sagof 2004). If I buy an orange, it is reasonable to interpret this as if I actually want an orange, and not as if I wanted an apple. Here, I believe, many of the classical-public-choice theorists draw a false conclusion when they say that there are fundamental differences between acting within the field of politics and acting within the field of economics.

Few public-choice researchers would accept the hypothesis that the voters vote for a political party because they approve of the party's policies – that social democrats vote for

the social democratic party simply because they are social democrats. This is probably something that most of us – as citizens – would disagree with.

In the world of politics, there are a number of phenomena that cannot easily be explained with traditional theories. The purpose of this paper is not to attempt to invalidate the public-choice theory, but to describe certain areas where insights from behavioural economics can increase the degree of explainability and point out new possible research areas³. The phenomena, or rather regularities, from behavioural economics I will use in this paper are the following:

- Status Quo-bias/loss aversion (Kahneman et al 1991) hangs more important than states.

Result: Path dependence and ratchet effects

- Endowment effects (Kahneman 1980, Knetsch & Sinden 1984)

Result: Path dependence and ratchet effects both when it comes to programmes and ideas

- Act on perceived rather than actual probabilities (Rabin 1998,2002), law of small numbers (Slovic 2000, Kahneman & Tversky 1971)

Result: Over/underestimation of the risk how having to resort to welfare

- Cascades and encompassing sentiment coordination (Bykhchandani et al 1992, Kuran 1996, Klein 2005) e.g. we tend to do as other people around us do without collecting new information.

Result: Path dependence and discrepancies between votes and representatives

- Self serving bias (Babcock & Loewenstein 1997). Overestimation of the validity of our own position.

Result: Hubris or over/underestimation of risks

- Kin rhetoric and “the peoples romance” (Salmon 1998, Klein 2005)

³A number of these will be treated in upcoming papers.

Result: “Unnecessary” solidarity

The implications of these regularities will be dealt with in the respective sections but the reader can already see that path dependence is a common denominator. Path dependencies are since David (1985) a central tool of analysis in economics.

3. When the voters and the politicians disagree

Self-serving biases help to increase the understanding not only of events as big and unsettling as wars but also of more mundane decisions. In combinations with information cascades, self-serving bias can contribute to a considerable gap between the policies that the political parties represent and the policies that the voters want (Kuran 1996). In most democratic countries, there are central issues where there is a deep divide between the majority of the voters and the majority of the representatives in the parliament. With a political system that allows free entry, you could assume that if the existing political parties did not match the voters’ view on one issue, there would be a new party that shared the views of the existing parties, but with a revised view on the dividing issue. However, this is not how it works. The politicians have created entry barriers in the form of regulations for party financing, percentage thresholds and government contributions to the established parties. Despite these obstacles, you could expect that there would be no systematic differences in opinion between the electorate and the elected. However, self-serving biases and cascade theory can explain why such differences emerge and are reproduced. The politicians may simply believe that their views are shared by the people – because they are the correct views. It is reasonable to assume that this is a process within the political institutions since it would be very difficult, if not impossible, to calculate which parties that would benefit from the long-term effects of certain welfare programs. There are just too many factors to consider - demography, economic development international relations and changes in preferences to mention a few – for it to be fruitful to try to determine voter movements in the decades to come.

This can be compared to an experiment in which test persons were to guess the outcome of a trial. Those who got the task to analyze the outcome from the defendant's perspective gave one answer, and those who got the task to analyze it from the plaintiff's perspective gave another. This happened in spite of them getting the same information (Loewenstein, et al 1993). Also in this experiment, it appeared as if the test persons assumed that the side that they represented was right. One can note that when politicians, or other elite groups, for instance realize that people don't share their views, they sometimes claim that people are victims of false consciousness or guided by "invisible structures". In this case, there is no intention to force an unpopular view onto the voters. Instead, the policies are directed by a genuine belief that they are executing the will of the people (Payne 1993) writes:

Everyone wants to have a high opinion of himself [...] When the congressman comes to Washington, he is surrounded by beneficiaries and claimants who are pleading for his 'help'. He is strongly invited to accept the role of philanthropist, strongly encouraged to believe that he has assisted people and left the country better off by funding government programs [...] This high self-opinion would be directly threatened if the donor of the funds [that is, the taxpayers] were brought into the picture. As soon as one recognizes that in order to help some people you have to hurt others, much of the glow goes out of being a congressman. For this reason, congressmen are reluctant to face the opportunity-cost issue.

These internal political processes can be explained with cascades (Kuran 1996, Kuran & Sunstein 1999, Bykhchandani et al 1992). If you are surrounded by persons who share your opinion, it is rational to assume that this opinion – or the perception of reality supporting it – is correct. To spend time gathering and processing information that could disprove your views is then irrational.⁴

These effects can be fortified by a deeper divide between the electorate and the elected. If the political units are small and decentralized, the elected will often meet

⁴This can explain why 85 percent of the members of the parliament wanted to adopt the EU constitution even though polls show that only one out of ten voters share this opinion (SvD 20050505).

voters; at the supermarket or at social events. This enables politicians to discuss proposals and to get ideas for new ones. Maybe more importantly, they meet the people who suffer from their policies (Slovic 2000). A centralized political system with a limited political class would, according to this theory, produce more policies that clash with the views of the voters than would be the case in more decentralized systems. The outcomes of referenda can be used to test this theory (Frey & Pommerehne 1993). In countries where politicians initiate the referenda, as Sweden, one could easily assume that a referendum would be initiated if, and only if, the political majority is convinced that the alternative that they advocate would win. In political systems where the people through citizen initiatives can force referenda – usually by collecting a certain number of signatures – as in Switzerland or in many American states, or in systems where referenda are mandatory to make some types of decisions, as in Ireland, you cannot expect that a certain outcome is more common than any other. If any side was more likely to win, it would be the side that forced the referendum. The required number of signatures is seldom comparable to the number of voters. However, one can assume that since it takes a lot of resources to collect the signatures, people abstain from undertaking such projects when the perceived chance of winning the referendum is slim.

The way that the political process works on a personal level can also have big effects. The personal cost of opposing a proposal that is supported by the other members of a political assembly can therefore be greater than the cost of opposing a proposal that is supported by citizens that you never meet. This would imply that bigger political units are less prone to make decisions that reflect the wishes of the voters. Arthur Montgomery argued that the most important institutional change in Sweden since the land consolidation reforms was the municipality mergers.⁵ On this point, he got support from Myrdal (1982),

⁵Here we can note that the municipality reform was introduced in part because the merged municipalities were considered necessary to deal with all the different programs that were needed in the new unified school system. Small municipalities were not thought to be able to offer a sufficient number of study programs. When the reform was done, however, the different study programs in the unified school system were almost gone, but the

who especially emphasized the increased gap between the electorate and the elected, and the loss of the social control:

The distance, both in geographical and human terms, to those in power has increased enormously.

These are no longer neighbours who know each other, live close to each other and close to the rest of the locals, and who are subordinated to the social control imposed by the local society [...] Small-scale solutions meant that we [when Myrdal was the mayor⁶ of Mariefred] constantly met in the streets, at home and at the local restaurant. This led to a local interest in what I did and to neighbour control.

This development contrasts that in places where a very decentralized decision making process has prevailed. In the Swiss canton Appenzell, the voters meet on the square to make collective decisions. This leads to some interesting results for the political decision making. The taxes, for example, have only been raised on the margin since the end of the 19th century. This has resulted in the social services being rather rudimentary. A conclusion to be drawn from this is that it seems to be more difficult to introduce taxation of others (few would vote for taxes that affected themselves negatively) if those who will pay the taxes stand next to you when the decision is made. The costs of the decision making should be weighed against the costs of the policies. Depending on your political views, you can also add negative effects that follow when the policies in demand have not been produced. But that is a natural consequence of democracy. This is an experiment that deserves to be explored further in future papers.

4. The Rhetoric of “The people’s home”

To talk about the society as a family or about the leader as a father is classical political rhetoric.

“The people’s home”, “the Fatherland”, etc, have often been invoked to motivate various kinds of government projects. Klein (1998) gives an explanation for how this can work:

Relationships in the household are communal and altruistic. Especially for the formative period prior to puberty, the child is reared obeying a supreme central authority that routinely circumscribes and overrides her own judgment and coordinates activities in a top-down fashion. [...] The family is the cradle of

reform was irreversible, at least politically (Myrdal, 1982). On this account Myrdal speaks about the latter of the two waves of municipality mergers and Montgomery about the first.

⁶ He was appointed not elected but obviously considered the residents of the Town his constituency

encompassing sentiment coordination. It is plausible that the individual's thought patterns would follow that mental model in dealing with other social issues.

Salmon (1998) agrees and argues that the artificial or metaphorical use of "kin rhetoric" is designed to exploit the natural solidarity between relatives. "*We address non-relatives by kin terms when we are attempting to promote solidarity and solicit aid*" There is strong evolutionary evidence for this theory. Klein continues:

Millions of years of primate evolution and more than one million years of human evolution in hunter gatherer bands of fifty to one hundred people might well have selected for TPR. Major group experiences were encompassing.

Since we have lived in groups where we have been relatively closely related to each other during the major part of our history, it has been a recipe for evolutionary success to help those surrounding us, but not to help those to whom we are more distantly related. This phenomenon is found among many species (see Daly & Wilson 1978 for an overview).

Salmon (1998) argues that the reasons for the success with political "kin rhetoric" are natural and based on the fact that we experience ties to relatives early in life, while friendship and reciprocity is experienced far later. This makes references to the former more powerful.

We do not need to be related to be affected by the kin references. Altruistic behaviour toward relatives is not sparked by the kin relationship as such (which is often difficult to ascertain), but by factors that are or have been closely correlated to kin relationships (Salmon 1998, Stack 1974). Johnson et al (1985) have in experiments showed that references to kin relationships (ex. "fraternity", "brotherhood", "soul sisters") in political speeches stir up a more positive response from the audience (the readers in this experiment) than the use of other words such as "neighbours" or "citizens". The result of the experiment goes well with less systematic observations of the political reality. "*The fact that politicians and union leaders persist in using kin terminology suggests that it is an effective strategy for arousing the emotions of an audience.*" (Salmon 1998).

A number of studies show that we tend to view persons who are similar to ourselves as “relatives”. This is true both for similar looks and similar behaviour (DeBruine, 2002; Burch & Gallup 2000; Lieberman et al 2003, Shepher, 1971, Platek et al 2002), and we tend to view these persons in a more positive light than others (Byrne et al 1971, Chen & Kendrick, 2002, Batson et al 1981). References to similarity should therefore be effective in political rhetoric. This, too, is an area that deserves to be the object of future research.

5. Path dependence and endowment effects

One of the most important theories in economic history is path dependency (David 1985, 2000). However, it is also possible to apply these theories on ideas. If you have advocated an idea for a long period of time – it could be a religious idea or a political – it is often difficult to give it up. This could also be viewed analogously with the endowment effect that has been observed in experiments (Kahneman & Thaler 1987, 1990). It is correct that this partly is a classic exit cost. Changing one's mind might infer reputational effects, but just as we can observe in other situations, people seldom consider such costs. In this case, we can assume that the costs primarily are lost credibility and prestige. Someone who has argued that the dividing line between “generous welfare politics” and “ruined welfare” goes at 90 percent compensation for sick absence and unemployment compensation will have a hard time accepting policies that lead to lower levels of compensation. The ownership effect can however add to the exit cost and make it harder to abandon ideas that are no longer viable.

Klein (2005) has also described a closely related phenomenon that he calls *encompassing sentiment coordination*, and that states that agents are rewarded if they embrace the same idea as others. One could also imagine that there are network externalities (David 1985) that make it difficult to change decisions made earlier. This is something that Myrdal (1982) observes when he studies the big municipalities:

Social developments are usually not reversible. Questions about taxes and debts are as difficult as in every divorce. Great buildings have often been built for the municipality's administration,

usually in the central community. At a division of a municipality, they were too big for the part of the municipality in which they were included, and too inconveniently located for other part. Because of earlier policies, a reversal to the previous order is considered too costly and despite the possibility of fundamental changes, already made investments block an adjustment of the policies to the new situation. One can assume that individuals work in a similar way. When a political program has been introduced (whether it is a tax regulation or a system for social-benefits), those who are included in the system adapt to the new situation.

The interest subsidies and the interest regulation lead to families buying houses to a greater extent than they would otherwise be likely to do (Borg 2004). A change would not be perceived as something positive by these families, and would probably be opposed or voted against. The voter are affected by the so called sunk cost fallacy, they fail to see it as a sunk cost and act accordingly. This will create path dependence. But this path dependence could also be on a non monetary kind – that they have invested intellectual capital into defending a previous monetary act – and therefore are ‘obliged’ to stick with it. The same phenomenon could possibly be behind the difficulties to reform the pension system. In this case, the issue is complicated by the fact that it is so politically charged due to its being describes as the crown of the welfare state (ref). In order for the pension reform to be realized, it had to be framed as a small change of the existing system, even though the reform had to do with fundamental principles behind the system (Molin 1965). To reach acceptance for the pension reforms, long periods to phase out the old system have been necessary. The result has been that those who were old enough to vote about ATP, the national supplemental pension scheme, in 1959 were allowed to stay in the old system with guarantee pensions while those who are younger, to a varied extent, are subjected to the new conditions.

6. Effects on the welfare politics

It is also possible to find applications for behavioural economics in the field of welfare politics, which improves the analysis compared to traditional public choice. I will here deal with a few applications that relate to the demand for welfare politics (this should be seen as an opposite to supply models in the field of welfare politics where the programs are created to provide bureaucrats with power or resources, or with demand models based on the assumption that voters through manipulations by those in power have been led into a state of government dependency that they cannot break out of).

Experiments have shown that we often overestimate the risk for extremely unlikely events (Slovic 1990). One explanation for the great demand for welfare services could be that the citizens underestimate the chances of success and overestimate the risk of ending up at the bottom of society. This could lead to welfare addiction, but those who estimate the risks differently could at the same time be against the welfare programs. How you estimate the risks could be related to historical and institutional factors, which could explain that there are often big differences in the welfare politics in different countries. The law of small numbers (i.e.. that we tend to overestimate the probability of very rare events) can in this instance give two diametrically different outcomes depending on which institutions it is combined with. It is these sorts of explanation models that are the strength of the behavioural economics. Someone who believes that there is a great risk of being killed in an airplane crash or by the side effects of a medicine will be prepared to make big investments to reduce these risks. At a personal level, it can mean avoiding air travel or avoiding medicines that you believe are dangerous. This behaviour brings personal costs with it. In the voting booth, however, is it much cheaper to embrace these kinds of principles for minimizing risks, and we get an integration of rent seeking and psychological demand factors affecting the decision. A result of this would be that the voters are stimulated to vote for things that have low private costs but possibly considerable negative effects on society.

Extensive research related to the results has been conducted (Libecap & Wiggins 1984, Keser & Gardner 1999) but note that the cause could possibly be found in the behavioural economics. This is another example of how the understanding can be improved by including these models.

7. Reference points and Ratchet Effects

The view that big changes (except for in very special circumstances) is not a feasible strategy for winning elections is a not very controversial.⁷ Through small changes, you can move the society in a direction that you desire without confronting too much opposition. When a subsidy or taxation base is established, it will be taken for granted and becomes an eternal constant. This goes well with the theories about status-quo effects, but the theory says nothing about what the politics will look like.

Another common phenomenon that relates to this is what is usually referred to as the ratchet effect, which makes the direction of the decisions more important than the level in absolute terms, often combined with the fact that it is easier to introduce laws, subsidies, regulations or taxes than to abolish them. This is expected to lead to an ever increasing quantity of legislation since what already exists will be taken for granted. Thereby, politics works like a ratchet that can only turn in one direction. Hence, political battles will as good as always be fought out between those who want to introduce new regulations and those who want to preserve status quo (Kingdon 1995). It is seldom the case that two proposals for change stand against each other. Politicians often think in these terms, and a complete ideological school, the reform socialism or the Fabianism, which often dominates the social democratic movements, is in principle based on these ideas even if this area of research emerged in recent years. That these ideas are significant, you can tell from what those in power say. In an interview Swedish Prime Minister Göran Persson, Peter Bratt writes the following in Dagens Nyheter:

⁷ A contrast to this is Higgs (1987) model about crises as a driving force for expansions. But this is less clear when we as Kingdon (1995) separate agendas and alternatives.

It is a way to transfer parts of the economic growth to the general welfare system without making it noticeable. The wage earners get a part of the standard improvement and give up the rest to the welfare system [...] There is a big difference between paying more of what you already have and getting less of what you don't yet have. That is how it has been done ever since the war. From 1950 to 2002, private consumption increased with 127 percent. During the same period of time, the public consumption increased with 274 percent. The growth was enough for both of these things. During this period, the tax rate, or the tax quota, that is the part of GDP that were paid to the government in taxes, increased from 20.5 to 51.8 percent.⁸

The public-choice explanation of the ratchet effects is that each time that the politicians introduce a new law, regulation, or subsidy, they create a group – sometimes a group of citizens but usually a group of politicians and government employees – that benefits from this measure. A new regulation must, for instance, be followed up by one or several government employees – people who will have reasons to obstruct if the program is abolished. As Olson (1965) shows, small and well organized groups often have advantages over larger but unorganized groups. In addition to the fundamental efforts to explain the great expansion of visible ratchet effects, insights within the field of behavioural economics can contribute with explaining factors that don't originate only from the bureaucrats affected by the measures but also from the public (that is the clients/buyers). The strength of the argument increases if factors that affect the demand are included in the analysis. These factors can contribute to the phenomenon, and originate from both bureaucrats and voters (as consumers of public goods).

Instead of starting from scratch with new legislation, the politicians and others in power take the existing legislation for granted and make small, gradual changes. By using that method, they don't have to create extensive systems of far reaching changes. They don't have to formulate the goals – they are given – and the changes that they propose are perceived as feasible (Kingdon 1995). A political program that has been established is seldom fundamentally questioned, it is surrounded by low levels of insecurity and the changes tend to be made in steps.

⁸ Peter Bratt. DN 20040410, also see Rodriguez 1981

An example of how fast such a process can go is the Swedish Högerpartiet's (the conservatives) quick acceptance of the ATP-system (Borg 2004, Edebalk, 1996, Molin 1965). Even though they strongly opposed a mandatory national supplementary pension scheme as late as 1959, they proposed that the system should be expanded in their 1962 election platform.⁹ Even if the acceptance of new programs is often a quick process, the introduction can take a long time. Borg (2004) shows for example that the 1994 pension reform was preceded by 10 years of studies and the introduction of *folkepensionen*, the universal basic pension system, was preceded by 36 years of studies.

Incrementalism can also be used as a method by those who want to manipulate the political process and its outcome. People are often unwilling to take big steps at once. When the decisions are made gradually, it is also more difficult to *see* what the final result will be. For these two reasons, those who advocate radical change often have to push for small parts of the change, one at a time. Once a program has been introduced, it becomes easy to expand it, new groups can be included, the requirements can be changed, etc. The trick is to get a foot inside the door. The difference between agendas and alternatives is that changes of the agenda occur in big jumps and not step by step. The creation of alternatives, on the other hand, is a step-by-step process. When those in power see which alternatives that they have, they choose the ones that they already know of and that go hand in hand with their ideology. The agenda, however, can change quickly, for instance through an election or an economic crisis (Kingdon 1995, also see Higgs 1987). It is often more difficult to go against a proposal if you don't view status quo as the alternative. If you don't do that, you have to formulate a complete alternative that cannot be objected to, and you also have to define your premises and explain what the goal is. To solve problems is often complicated, and there is no correct answers to be had beforehand.

⁹ One cannot say that they simply adjusted themselves to the result of the referendum since the referendum did not give a clear majority in favour of any of the three alternatives. Instead, the issue was settled in the parliament, where the support from a member of Folkpartiet (the Liberal party) was needed to push through the government's proposal.

Loss aversion can also explain macroeconomic phenomena such as (downwardly) rigid (nominal) wages. This is a common assumption in economics and the explanation is often thought to be so called menu costs (Romer, 2001). Behavioural economics can give a better explanation in this instance. Since the economic agents are loss avert and guided by a status-quo bias, a cut in the real wage that is caused by a cut in the nominal wage is perceived as worse than a cut in the real wage that is caused by a decreased money value. (For an opposite view though, see Blinder et al 1998)

Experiments conducted by Kahneman, et al (1986) confirm this thesis. They found that the acceptance for a wage cut in a zero-inflation economy was smaller than the acceptance of no wage raise in an economy with high inflation, even if the outcome in real terms was the same. The concept of money illusion is important in Keynesian economics. It says that economic agents make their decisions based on nominal rather than real income, a theory supported by behavioural economists. Baker, et al (1994) and Sharif, et al (1997) have shown that employees accept real-wage cuts as long as the nominal wage is not cut. Also in this case, the major part of the research has dealt with phenomena on the financial markets. A classical example (Odean 1998) that is usually used to illustrate the loss aversion is the following: You have two shares on the stock market, one that has increased in value and one that has decreased in value. You have to sell one of them to repay a debt. Which one do you sell? Many people answer that they would sell the share that has increased in value even though – at least in a world with capital-gain taxes – is more beneficial to sell the one that has decreased in value.

The same effect is found on the real estate market. Genegove & Mayer (2001) have shown that the advertised prices of apartments in Boston are strongly linked to the prices that the apartments were bought for. According to neoclassical theory, the apartment seller should view the price that he or she has paid as a sunk cost and not let it affect the selling price. But since people hate to sell things and make a (nominal) loss, the buying price matters.

The behavioural economic theory that is most widely known among laymen is the phenomenon that makes people demand much more to sell a good that they own than they would be willing to pay to acquire it. Kahneman (1980) named this phenomenon the endowment effect or the endowment effect. In a classical experiment, Kahneman, et al (1990) provided half of the test persons with a coffee cup. They were then asked at what price that they would be prepared to sell the cup. The half of the group that was not given a cup was asked what they would be willing to pay for a cup. According to neoclassical theory, there should be no difference between these buying and selling prices. However, in the experiment, the selling price was 5.79 USD and the buying price was 2.25 USD. This result has been repeated several times (Knetch & Sinden 1984, Knetsch, 1989, Kahneman et al 1990). The explanation is said to be that those who got a cup saw it as theirs and were reluctant to give it up while those who got no cup saw the cups as just any cups. Samuelson & Zeckhauser (1988) called a similar phenomenon the status-quo bias – this phenomenon had to do with the unwillingness both to sell and to buy anything. The asymmetry is, just like the endowment effect, related to what Kahneman and Tversky (1984) called loss aversion.

Experiments conducted by Loewenstein and Kahneman (1991) show that the endowment effect is not sparked by someone receiving a gift¹⁰, but only from the "pain" that arises when people have to give up something that they have. Do the agents consider the endowment effect – do they expect that it will affect them? Loewenstein & Adler (1995) find no support for that hypothesis. However, Kahneman, et al (1990) expect that there are situations in which the agents do this: *"There are some cases in which no endowment effect would be expected, such as when goods are purchased for resale rather than for utilization"*. This has been confirmed by List (2003). In addition to this, Loewenstein (1998) has shown that the intensity of the endowment effect depends on how long the item had been owned, whether it had been lost before, for how long it

¹⁰ Gift giving is however an area that might be explored as a field where behavioural economics can provide new insights in welfare policy.

was gone and for how long it had been owned when it was lost. A test of the status-quo effect was conducted by Hartman, et al (1991) and dealt with electricity customers in California. The customers were asked how they viewed different combinations of service and prices where one of the combinations was status quo. Regardless of whether it was a combination of a low price and little service or of a high price and a lot of service that was describes as status quo, most people chose that alternative (also see Kahneman, et al 1991). We should be able to observe the same effect when it comes to people's view of the pension system or the sickness insurance system.

8. Going further

In this paper, I have pointed out areas where insights from Kahneman, Tversky & Slovic can be used to improve the analysis of political decision making and design of different political programs, primarily relating to taxes and welfare. The modern analysis of political decision making that the public-choice school has created has meant a lot for increasing the understanding of these areas. The economic-historical institutional analysis is also valuable in these efforts. How institutions originate and change in different societies and different times gives us insights on which factors that drive the development. Also the theories from economic history about path dependency and network externalities are powerful tools. There are, however, room for new models. By adding a demand model and trying to analyse which demand on different types of political services that can be related to the regularities that economic-psychologists had found, the analysis can be made more complete.

If we add the behavioural insights to the classical public choice models we should be able to see more rigidity on the political market than with just public choice because not only the rent seeking effects but also mental effects will create path dependencies. The supplement could also explain why these rigidities take the shape they do.

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