Anomalies the Endowment Effect, Loss Aversion, and Status Quo Bias (Kahneman, Knetsch, and Thaler 1991)

Classical economics assumes that agents behave rationally. Rationally implies that people behave as if they know the best possible answer to each decision problem. The field of *behavior economics* lift this assumption and tries to understand how people behave when they are not rational. Humans behave rationally on some occasion, while emotionally on others. Think all those times you regret buying something. If you were rational, that purchase should've been best possible one.

One Sentence Summary

Loss aversions is the idea that a loss hurts more than the satisfaction of a win. The endowment effect is a consequence of loss aversion. It captures the emotional attachment to personal belongings, increasing the *sell price* of the item. Status quo bias is the tendency for humans to reject most change, even when it's for the better.

Main Findings

Microeconomic theory tells us that an individual will have the same magnitude of *utility* gain from five dollars as the utility drop of losing the same amount. However, humans lose more utility from losing five dollars than the utility gain of an extra five bucks. This anomaly was coined as *loss aversion* by Nobel Laurette Kahneman (1984). Some consequences of this are the endowment effect and status quo bias.

We put an emotional value to our belongings just because they are ours, not because we prefer them. The endowment effect raises sell prices even if the item does not bring us utility. Hording is a behavior in which items that are not used — not providing practical utility — but we keep them around, because losing them could produce a bigger drop on utility.

Imagine this situation: the first day of class, the professor hands out free coffee mugs to half the class at random. He tells everyone to inspect the mugs to discover the six-dollar price tag. Classical economics would predict that half of the mugs would be traded. If you don't value a coffee mugs, then you would sell it for any price. Why? Because the mug was free, therefore two dollars are more valuable to you than a mug. In the experiment the trade volume was between 5% and 18%, way below the predicted 50%. Some *mug haters* valued the mugs for a higher price than those who wanted to buy them, even though the rational choice for them is to sell at any price. Several other experiments were conducted with other items and the same effect was found.

As humans we tend to reject change. A reason for this is loss aversion, we have so much to lose from a change. The tendency to remain unchanged is called the *status quo bias*.

For example, on a five-year period your chosen phone plan might not be the best one. Imagine that you have an initial phone plan with 300 text messages and 1Gb of Internet usage. You've sent 4 text messages on average per month. A new plan comes out with 5Gb of Internet

and 10 text messages. Even when you wished for more internet bandwidth you refuse to change. Because the possible bad event of needing to send an eleventh text message outweighs the gain of 4Gb gain. Therefore, you stick to your initial plan even though the upgraded one is better for you.

Concluding Remarks

Understanding these phenomena are paramount to understand behavior. When economist handle complex topics like gender gaps or poverty is important to understand how people react and behave. The documentation of loss aversion has explained much of the data that rational models could not and it's a cornerstone of behavioral economics today.

References

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