Loss Aversion

This video introduces the behavioral ethics bias known as loss aversion. We hate losses about twice as much as we enjoy gains, meaning we are more likely to act unethically to avoid a "loss" than to secure a "gain." This phenomenon is known as loss aversion and must be guarded against.

People can relate to the notion that loss aversion has an impact on tax cheating. People will cheat more to avoid a loss than to secure a gain. So, if they have over-withheld, they are less likely to cheat in order to obtain a larger tax refund (which they view as a gain) than they are to cheat if they have under-withheld and are trying to avoid making a tax payment (which they view as a loss).

Students can usually grasp the idea of loss aversion and relate to it in their everyday lives. A student is more likely to cheat to avoid flunking out of school (a loss) than to move from a B to an A (a gain), unless the student has a 4.0 GPA and views the potential B as a loss.

In life, loss aversion often means that people who have made mistakes and perhaps even violated the law through carelessness or inattention often will, upon realizing that fact, take their first consciously wrongful step in order to attempt to ensure that the mistake is not discovered and they do not lose their job or their reputation. They will lie, they will shred, and they will obstruct justice.

In business, loss aversion also means that firms that are performing well, but not as well as they expected to or as well as others expected them to, may engage in unethical behavior because they frame their act of profiting (but not profiting as much as expected) as a loss rather than a gain.

Loss aversion is related to the behavioral ethics concept of framing because the same situation can often be framed as a potential loss or a potential gain, and the difference in framing can definitely affect people's decisions. To learn more about this concept, watch *Framing*.

To learn more about how the ethical dimensions of decisions can fade from view, watch *Ethical Fading*.

The case study on this page, "The Collapse of Barings Bank," details an extreme case of loss aversion when investment banker Nick Leeson, faced with growing losses, took big risks in attempt to get out from under the losses with dyer effects. For a related case study about the famed fall of a major energy company due to dubious practices, read "Selling Enron."

Behavioral ethics draws upon behavioral psychology, cognitive science, evolutionary biology, and related disciplines to determine how and why people make the ethical and unethical decisions that they do. Much behavioral ethics research addresses the question of why good people do bad things. Many behavioral ethics concepts are explored in detail in ***Concepts Unwrapped***, as well as in the video case study ***In It to Win: The Jack Abramoff Story***. Anyone who watches all (or even a good part) of these videos will have a solid introduction to behavioral ethics.

Terms defined in our ethics glossary that are related to the video and case studies include: ethical fading, framing, loss aversion, moral cognition, and moral emotions.

Discussion Questions

1. Studies show that people hate losses twice as much as they enjoy gains? Is that consistent with your experience?
2. Have you ever been caught off guard doing something you probably shouldn't have been doing (eating the last cookie in the cookie jar, peeking in someone's diary, touching your mother's jewelry) and when surprised with the question: "What are you doing?", quickly and almost automatically (and falsely) said: "Nothing!"
3. Nick Leeson famously almost sank Baring's Bank when he lost a big chunk of money, but was too embarrassed to admit it and then doubled down trying to make the money back before the loss was discovered. The losses grew and grew (to more than $2b) as he took increasingly risky bets. Indeed, this is a famous pattern in financial frauds including those involving Jerome Kerviel (lost $6.3b trading for France's Societe Generale) and John Rusnak (lost $691m trading for Allfirst Bank). Does it seem to you that loss aversion plays a role in this dynamic?
4. A recent study found that when people were under time pressure, they were more willing to cheat to avoid losses ("losing the sale") than to accrue gains ("getting the sale"). Do you think that is how you would react?
5. Can you think of any situations where you or someone you know may have made decisions affected by loss aversion?
6. Evidence indicates that over-withholding of taxes reduces tax cheating. Can you explain why?
7. What steps can people take to minimize the chance that loss aversion will help lead them to act unethically?

Additional Resources

Kern, Mary C., and Dolly Chugh. 2009. "Bounded Ethicality: The Perils of Loss Framing." *Psychological Science* 20 (3): 378-384.

Mishina, Yuri, Bernadine J. Dykes, Emily S. Block, and Timothy G. Pollock. "Why "Good" Firms Do Bad Things: The Effects of High Aspirations, High Expectations, and Prominence on the Incidence of Corporate Illegality." *Academy of Management Journal* 53 (4): 701-722.

The latest teaching resource from Ethics Unwrapped is an article, written by Cara Biasucci and Robert Prentice, that describes the basics of behavioral ethics, introduces the videos and supporting materials along with teaching examples, and includes data on the efficacy of Ethics Unwrapped for improving ethics pedagogy across disciplines. It was published in Journal of Business Law and Ethics

Pedagogy (Vol. 1, August 2018), and can be downloaded here: "Teaching Behavioral Ethics (Using "Ethics Unwrapped" Videos and Educational Materials)."

For resources on teaching behavioral ethics, an article written by Ethics Unwrapped authors Minette Drumwright, Robert Prentice, and Cara Biasucci introduces key concepts in behavioral ethics and approaches to effective ethics instruction—including sample classroom assignments. The article, published in the *Decision Sciences Journal of Innovative Education,* may be downloaded here: "Behavioral Ethics and Teaching Ethical Decision Making."

A detailed article by Robert Prentice with extensive resources for teaching behavioral ethics, published in *Journal of Legal Studies Education,* may be downloaded here: "Teaching Behavioral Ethics."

An article by Robert Prentice discussing how behavioral ethics can improve the ethicality of human decision-making, published in the *Notre Dame Journal of Law, Ethics & Public Policy*, may be downloaded here: "Behavioral Ethics: Can It Help Lawyers (And Others) Be their Best Selves?"

A dated but still serviceable introductory article about teaching behavioral ethics can be accessed through Google Scholar by searching: Prentice, Robert A. 2004. "Teaching Ethics, Heuristics, and Biases." *Journal of Business Ethics Education* 1 (1): 57-74.

Transcript of Narration

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"Psychological tendencies and organizational pressures can cause even good people to act unethically. Consider *loss aversion,* which is our tendency to prefer avoiding losses to acquiring gains. You probably won't be surprised to learn that people detest losses about twice as much as they enjoy gains.

Loss aversion is related to *prospect theory*, developed by Nobel Prize winner Daniel Kahneman and Amos Tversky, which includes the notion that people will take much greater risks to avoid losing what the things have than they would have taken to gain them in the first place.

All this means that people who perhaps inadvertently commit an unethical act will often consciously decide to lie to cover up their inadvertent mistake. In order to get his coaching job in the first place, former Baylor University basketball coach Dave Bliss probably would not have stooped so low as to try to pin a false drug dealing rap on one of his players who had been murdered. But in order to avoid the loss of that same job, Bliss did exactly that.

Bernie Madoff's massive Ponzi scheme may well be explained, in part, by loss aversion. Madoff has explained that he had made trading errors before, but when it appeared that his entire business model was wrong, he committed fraud not so much to get rich, but to cover up his mistake. He said: "I refused to accept the fact—could *not* accept the fact that for once in my life I had failed. I couldn't admit that failure and that was a tragic mistake."

A recent study Schrand and Zechman found that companies often unintentionally overstate earnings, perhaps due to over optimism, but this gets them into a situation where in order to avoid having to admit an embarrassing error, they will begin intentionally misleading investors to avoid a hit to their reputation. Martin Grass, CEO of Rite-Aid Corporation provides an example. After being sentenced to eight years in jail for accounting fraud, Glass admitted: "[W]hen things started to go wrong financially, I did some things to try to hide that fact. Those things were wrong. They were illegal. I did not do it to line my own pockets."

Remember that Martha Stewart didn't go to jail for insider trading. She went to jail for obstructing a federal investigation into that insider trading in an attempt to avoid a loss of reputation. And the accounting firm Arthur Andersen was convicted not of securities fraud but of shredding two tons of documents to try to cover up its errors and avoid potential fines.

To be ethical people, we have to monitor our own actions and motivations constantly. And we may need to muster the courage to admit to even our most painful mistakes."