Does Loss Aversion and Status Quo Bias Impact the Overall Size of Government?

Idea for Future Research

By James Sly

At the beginning of the 20th Century, the United States had a relatively small government, where taxes and spending both remained below 5% of GDP for the first few decades excluding WW I. This is in contrast to modern day economies, where the vast majority of OECD countries have tax and spending levels that fall between about a third and a half of the size of their overall economy, including the United States. One major trend in the United States, and other developed economies, is the overall growth in the size of government during the 20th Century, where this time period represented a transition from a small size of government to a larger, more optimal size of government.

One major impediment to this transition from a small government to a larger government during this time is the status quo bias that results from loss aversion. If you are a politician trying to permanently increase the size of government, you need to pass spending increases as well as the tax increases that are used to pay for it. Spending increases are an improvement over the status quo, so these are perceived as gains, while tax increases are a detriment, so these are perceived as losses. This means that the politicians are going to find that increasing the size of government is going to be unpopular overall and difficult to enact, since any tax increases are going to be equal in size to the spending increases, but, due to loss aversion, the tax increases are going to be felt twice as powerfully since they are losses, compared to the spending increases which are felt as gains. This is how status quo bias develops, and it likely creates a significant headwind to any attempt to increase the size of government over time.

One interesting area of research is to study how governments overcame these headwinds that arise from loss aversion and status quo bias, and I have identified three possible strategies. The first way politicians can get around status quo bias and increase the size of government is to increase taxes to pay for a war, but then raise non-military spending just after a war. This allows the government to spend more on other areas after a war, but instead of needing to raise additional taxes, they simply have to lower taxes less than they raised them to pay for the war. This means that after a war is over, politicians need to decide how much to lower taxes from the wartime high (which changes the size of the gain), and how much to increase non-military spending (which also represents a gain). For politicians, this is much easier to do, since they are trading off a smaller gain for another gain, rather than trading off a gain for a loss. This dynamic developed in the United States after both WW I and WW II, where after WW I, the US spent 9 times more after the war in 1920 than they did before the war in 1916, and after WW II, the US spent about 3 times more after the war was over in 1948 compared to before the war in 1940. Similarly, in the United Kingdom, they engaged in a dramatic expansion of their social safety net after the war concluded in that country as well.

The second way politicians can get around status quo bias is to do the changes piecemeal, first by increasing spending early on and letting people get used to their new benefits, only to increase taxes at some point later in the process. Doing the spending increases by themselves first is popular since the public gets a valuable benefit, without any corresponding loss in the form of higher taxes. This would likely have to be paid for with temporary budget deficits, but this creates significantly lower resistance, since the investors who provide these funds get their money back (plus interest) and the public does not have to pay any additional taxes at first. Eventually, however, the deficit needs to be closed and taxes need to be raised, but it is easier to raise taxes to close deficits, since any spending cut will be felt as a loss, while any tax increase will be felt as a loss too. When closing deficits then, politicians face a tradeoff between a loss and a loss when trying to raise taxes, which are both equally unpopular, and is significantly easier than trying to raise taxes, a loss, to pay for spending increases, which is seen as a gain. In the United States, this approach was one of the strategies used to increase Social Security benefits over time, where politicians often passed an increase in benefits right before an election, and then passed the tax increases to pay for it just after the election, overcoming the status quo bias by doing it piecemeal, as well as exploiting some advantages in election timing. France also might have adopted this approach since the mid-1970s, dramatically increasing spending first during good economic times, then closing the deficits that resulted by increasing taxes to pay for it, along with some smaller cuts to spending as well. This strategy in reverse is what motivates the starve the beast mentality that tries to reduce the size of government by passing tax cuts first, then letting the public adjust to these new levels, only to try and cut spending afterwards to close the deficits that result.

The third possibility is that a parliamentary system of government makes it easier to overcome status quo bias. In a parliamentary system, the prime minister and parliament are always controlled by the same party, though often in a coalition with other parties. This could make it easier to pass spending and tax increases at the same time, since minority parties have less power to block major reforms. One interesting question is whether countries with fractured party systems have more difficulty increasing the size of government compared to one with only two major parties. The United States has a presidential system, and a bicameral legislature, where one of the houses has a super majority filibuster requirement that gives even more power to the minority party to block important legislation. This unique political structure in the United States might make it more difficult to increase the size of government over time, and may have been part of the reason why the country has been so slow to adopt universal health insurance for example.

In general, over the last 100 years, countries across the developed world have wanted to keep increasing their overall size of government, even though status quo bias makes it more difficult for them to do so. Examining the budgetary dynamics of many developed countries would yield some insight into how politicians overcame this status quo bias and managed to get the size of government much closer to their optimal levels. This would help us identify the impact that loss aversion has on the overall size of government, providing a new line of research for behavioral public finance on one of the most important public finance questions in the field.