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How to use learnings from behavioral finance theory to lead change and improve democracy in future turbulent times in Spain and in the European Union

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Abstract

Traditional finance theory has had a big impact in modern societies, helping to understand and deal with uncertainty. However, new behavioral finance theory, built upon irrational players, is changing the way we should look at risk in finance. Can we make an analogy from these ideas to better understand the new leadership styles needed in countries like Spain to face the coming turbulent democratic challenges in the European Union?

Keywords: Behavioral Science, Finance, Leadership, Democracy, European Union.

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Impact of behavioral science in finance

Jonathan Berk and Peter DeMarzo, from Stanford University, explain in detail in their book "Corporate Finance" how modern traditional finance was built using the concepts of efficient market hypothesis and rational investors that take decisions to maximize reward and minimize risk. All these ideas were developed using deterministic mathematics that come from theoretical physics. It has been a very powerful tool that has guided the growth of financial markets and modern capitalism, and that focuses on maximizing shareholders' value of corporations. Also, it created interesting models to differentiate between systematic and firm specific risks, introducing the concept of investments diversification, which has been key for average investor prosperity and for society in general.

However, as Frederic S. Mishkin, from Columbia University, explains in his book "Financial Markets and Institutions", after the 1987 stock market crash, economists like Robert Shiller developed a new field called behavioral finance. It incorporated concepts from other social sciences like psychology and from prospect theory ideas written by Kahneman and Tversky in 1979. In their famous paper they demonstrated that humans are not as rational when taking decisions as it was traditionally thought. In finance, all this had an important impact summarized by Mishkin:

- People are subject to loss aversion versus risk aversion. They are unhappier when they suffer losses than they are happy when making gains. For this reason, very little short-selling actually takes place, reducing the pressure to decrease the price of stocks when they are too high. So, stocks are on some occasions irrationally overvalued.
- People tend to be overconfident in their own judgments. This explains why securities markets have so much trading volume, higher than what rationale behavior could explain.
- Overconfidence and social contagion explain stock market bubbles. Positive feedback loops in which prices continue to rise, produce a speculative bubble, which finally crashes. In the end, many innocent investors buy the stocks when prices are high and sell them when prices are low.

Behavioral finance is young, but it seems it will be able to explain and correct behaviors that are not well understood using the traditional rational investors and efficient market hypotheses.
Andrew Lo, from MIT, in his book "Adaptive Markets" tries to reconcile theories based on the efficient market hypothesis with behavioral economics by applying the principles and the math of evolution to financial interactions versus the traditional financial deterministic math from theoretical physics.

Impact of behavioral science on democratic rules

In the previous section we showed the transformation and challenges that prospect theory, with the ideas of irrational human decision making, is bringing into finance. The question now is simple. Is it possible to make an analogy of this reasoning regarding the rules of democracy? In other words, we, as citizens, as individual voters, tend to assume that we are rational voters. So, democracy works properly because if a leader takes bad decisions, voters will punish him. But what happens if we consider, like in finance, that voters are not so rational? How do we reduce the risk that politicians take advantage of this voter's irrationality using messages to provoke certain behaviors?

These look like important questions because, like in finance, if we understand better the irrationality of the voters and how to combat it, we should be able to create stronger democracies, which are key for the progress of business and society. Accepting that democracy is fragile, and that we should care about it and protect it from human irrationality, is the first step to start thinking about possible solutions. Also, it serves as a good starting therapy for average voters who do not understand how narcissistic psychopaths, and liars are able to succeed and win elections. The same that accepting that investors are not rational is the first step to understanding that financial bubbles do exist.

Paul Collier, from Oxford University, in his book "The Future of Capitalism: Facing the New Anxieties", makes some interesting analysis and gives us some clues to answer these questions. He explains that:

- The catastrophes in the 20th century were provoked by political leaders who either had embraced ideologies with passion or had disseminated populism. Successful leaders were pragmatic. They shunned ideologies and focused on solutions. They founded their action on moral values, without ideology.
- The reasons must be founded on values, not the opposite. As Hume and Adam Smith said, "the reason is slave of the passions." From here, the philosophy of pragmatism defended the interrelation between common moral values and practical reasoning. We should use practical reasoning to deduct the correct course of action. Pragmatism asks continuously: "What, here and now, is it most likely to work ?"
- Stories are very powerful. George Akerloff and Robert Shiller wrote, "stories do not only explain the facts, but they are also the facts." What is true for financial crisis, is thus also applicable to the outbreak of mass violence. The best way to predict these outbreaks it is to observe the stories that are circulating in the mass media.
- Commitments are very important. We need the "Technology of Commitments" to solve the "Problem of Temporal Inconsistency."

In the same way that finance is being reinvented because of behavioral science to protect investors, analogously, it looks interesting to try to identify ideas that can help protect democracy from the irrationality of voters, which populist leaders could try to use for their advantage.

Ideas to improve democracy and to deal with turbulent challenges in Spain and the European Union

Let's start by focusing on Spain. In *The Economist* dated April 25th, 2024, in the politics section appears a news item with the title, "Drama king: Will Spain's prime minister suddenly quit? Pedro Sánchez stunned Spain with a promise to announce plans on April 29th". The article starts with the sentence: "Pedro Sánchez knows drama." In relation to what it has been mentioned in the previous section: is it Mr. Sánchez, with his "rickety majority", an example of playing with stories to dramatize a populistic plebiscite? The reality is that with this letter he has got the attention of Spanish population, people against or in favor of him, during the five days he has taken for personal reflection, unexpectedly. As the article says at the end: "Only the dramatic Mr. Sánchez knows."

Is this action an egocentric way of understanding democracy and taking advantage of the irrationality of voters who accept populist measures? Adam Grant in his book, “Givers and Takers: Why Helping Others Drive Our Success”, explain very well how to discover very easily this type of narcissistic and egocentric leaders whose actions usually result in tremendous catastrophes, like what Paul Collier described in his book.

Let's move to the broader context of the European Union (EU). Can the EU help to reduce these risks for societies and democracies like Spain? What role could the EU play to protect member countries like Spain against irrational voting? And to offer protection against populism and ideologies?

The first idea that looks important is the role of the EU defending strong and independent institutions in all dimensions of society (monetary, legal, media, social, economic, accounting…). We know that strong institutions are key to protect democracy against populism and human irrationality. They bring objective and independent analysis and conclusions from different competence areas, offering higher levels of reasoning and reducing populism.

The role of the EU in protecting institutions is important and challenging. Understanding that institutions are the first barrier against irrational voters and populist politicians, helps to focus on the task and helps to overcome the difficulties. On some occasions, we focus too much on all the problems of the EU, blaming it as a huge bureaucracy, but it seems very important to emphasize that the role of the EU is very important to protect institutions. The coming European elections will be a very important moment for all Europeans to talk and reflect altogether about all these issues.

Making an analogy, we mentioned that in finance, once we know investors are not totally rational, we need new methods coming from behavioral science and evolutionary math, explained for example in the book of Adaptive Markets. In a similar reasoning, to protect democracies like Spain from irrational voting and populist leaders, it seems that the construction of the EU and its institutions is very important.

Once the importance of reinforcing institutions has been emphasized, the second idea should be to analyze what can be done with the people who constitute these institutions, mainly politicians. For this purpose, I am going to talk about Total Leadership, a methodology developed by Professor Friedman, from The Wharton School, that has been extensively used in the corporate world to “Be a Better Leader, Have a Richer Life.” In the corporate world this has helped tens of thousands of people to develop healthy leadership human values by learning in community to: “Be Real, Act with Authenticity; Be Whole, Act with Integrity; Be Innovative, Act with creativity”. Carlos Casanueva, from ESCP Business School, describes this extensively in his paper, “Leadership and Human Values to Make the Change in the Right Direction in the Modern Service Oriented Society.”

Total Leadership works for people with different ideologies because it focusses on universal humanistic values, and proposes actions and solutions for oneself and for others. It emphasizes storytelling and peer-to-peer coaching thus creating connections, growing empathy, and improving personal life, in turn creating a big opportunity cost against corruption. It seems it should be mandatory for all politicians to be trained periodically in this methodology, or something similar, to foster healthier leadership and reduce the risks of populisms and passionate adherence to ideologies. A small improvement in the quality of the leadership of politicians would have a huge impact on society, due to the tremendous power that politicians accumulate.

The third idea relates to the voters. It is obvious that increasing the education and training of the population is an excellent way to reduce their irrationality and protect them against dangerous populism. In this light, the role of educational institutions like ESCP becomes crucial.

Conclusion

Democracy is not as solid as we would like it to be. The irrationality of voters, described by behavioral science, makes it possible for inappropriate leaders to grab power with tricky games. To protect society from these undesirable, less-than-democratic situations, actions should be taken, and we need all of us to think about this. The three actions proposed in this paper should be considered as food for thought: protect institutions, train politicians with appropriate leadership methods that enhance human values, and educate voters.

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