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Not all financial speculation is treated equally: Laypeople's moral judgments about speculative short selling

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ABSTRACT

Since the recent financial crisis, regulators and the general public have focused on financial speculation as one of its potential causes. In addition to the roles played by rating agencies and complicated financial engineering, speculative short sales have been put into question. However, laypeople's moral judgments about this type of financial speculation have rarely been investigated in economic psychology. The present study aims to fill this gap. Across four studies, we find that laypeople's moral judgments of short selling are significantly harsher than their judgments of long positions. Both successful (Study 1) and unsuccessful (Study 2) short selling receives harsher moral judgments. In addition, studies which manipulate the moral character of the shorted asset (Study 3) or the time horizon of the investment strategy (Study 4) support the conclusion that short selling is considered less moral than taking a similar long position. The results present consistent support for a judgment bias of economic laypeople in the domain of financial economics.

1. Introduction

The great financial crisis following the American crisis in subprime mortgages has led to strong declines in growth and wealth all over the world. After the world's financial system stabilized, the subsequent national debt crisis in the Euro Zone raised a debate about the appropriate political measures to implement that could potentially eliminate the causes of the crisis. In addition to the role played by the rating agencies and complicated financial engineering, the lack of regulation of financial markets quickly arose as a critical element that preceded the crisis. In particular, speculative short selling (e.g., borrowing and selling securities or stocks that one does not possess to profit directly from their depreciation or short selling via derivatives) has become the focus of the public debate.

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The aim of the current paper is to address laypeople's judgments about the morality of speculative short selling. There is no question that the judgments of laypeople (i.e., non-experts) have a critical influence on political decision-makers as they propose political measures. As shown in political economic research, rational political decision-makers might bias their decisions toward the median voter to win elections (Downs, 1957). Thus, laypeople's systematic judgment biases might directly impact political decisions because opportunistic politicians might adopt policies based on these (biased) lay judgments. Building on the research on laypeople's perceptions of economics (Baron & Kemp, 2004; Caplan, 2008; Enste, Haferkamp, & Fetchenhauer, 2009; Gangl, Kastlunger, Kirchler, & Voracek, 2012; Haferkamp, Fetchenhauer, Belschak, & Enste, 2009; Jacob, Christandl, & Fetchenhauer, 2011; Kemp, 2007, 2008) as well as the psychology of moral judgments more generally (Greene & Haidt, 2002; Haidt, 2001), we argue that people regard speculation on "falling" markets (i.e., short positions) as morally worse than traditional investments in which one participates in rising markets (i.e., long positions).

1.1. Laypeople's moral perceptions of economic phenomena

In economics and economic psychology, a large body of literature indicates that there are differences in the judgments made between experts and laypeople regarding economic policy (Baron & Kemp, 2004; Caplan, 2008; Enste et al., 2009; Gangl et al., 2012; Haferkamp et al., 2009; Jacob et al., 2011; Kemp, 2007, 2008) and more general economic phenomena, such as growth and inflation (Christandl & Fetchenhauer, 2009). Two findings of the research on laypeople's perceptions of the economy are particularly relevant to judgments about speculative short selling. First, many researchers have addressed laypeople's judgments in various areas of socio-economic policy. A common finding of these studies is that there is a systematic difference between laypeople and economic experts regarding *regulation by the government*. While economists generally support measures that involve freedom of trade or labor mobility (Alston, Kearl, & Vaughan, 1992; Coughlin, 2002; Jacob et al., 2011), laypeople tend to endorse more regulatory activities (Kemp, 2007), such as protecting domestic workers with minimum wages or bans on immigration. Second, unlike economic experts, who primarily judge economic measures in terms of efficiency, economic laypeople mainly base their acceptance of socio-economic policies on subjective estimates of fairness (Haferkamp et al., 2009). In more simplistic terms, an economic policy measure will only be accepted and supported by laypeople if it is regarded as fair.

This finding raises the question of how people form moral judgments and judgments about the fairness of economic phenomena. Researchers in the field of psychology have thoroughly investigated how judgments of fairness are reached. Consistent with the primacy-of-intuition approach (e.g., Haidt, 2001; Zajonc, 1980), social cognition research supports the dominance of intuition by showing that many of our social judgments and behaviors are automatic, i.e., performed without intention or awareness and effortlessly (Bargh, 1994; Bargh & Chartrand, 1999). Thus, unlike models of moral cognition (Kohlberg, 1969; Piaget, 1932), which generally assume that moral judgments are the result of a reflective, conscientious cognitive process, moral judgments are increasingly observed as products of intuition (e.g., Haidt, 2001) followed by Post Hoc rationalizations to justify the intuition. In the case of financial speculation, rather than carefully weighing the arguments in favor of or against short selling (i.e., reflection), moral psychology suggests that moral judgments about speculative short selling might be based on a gut feeling (i.e., intuition).

1.2. Moral judgments about speculative finance

The literature about laypeople's perceptions of economic issues and moral psychology suggest that financial regulations (e.g., bans on speculative short selling) might be popular because the objections to short selling are intuitive, whereas understanding the upsides of speculation usually requires reflective judgment. Harsh moral judgments by the general public might be one important prerequisite of regulatory activity, especially if politicians are motivated by the median voter (Downs, 1957). However, to our knowledge, moral judgments about a particular direction of speculation – in our case, short selling – have never been systematically investigated. The present research aims to fill this important gap.

More or less implicitly, financial speculation – either short or long – has always been subjected to moral judgment. In fact, financial speculation has been viewed as somewhat similar to gambling, which is – to say the least – more closely associated with immoral behavior than moral behavior. Quite tellingly, Ernest Cassel stated: "When I was young, I was called a gambler. As the scale of my operations increased, I was known as a speculator. Now I am called a banker. However, I have been doing the same thing all the time" (Cassel, cited in Chancelor (1999)). In fact, the prominent arguments against speculation include the assertion that it is similar to gambling and serves no real economic function (e.g., Hazen, 1991). Nevertheless, the morality of behavior should not depend on the *direction* of a particular belief or on the time frame. It should not matter whether an individual bets on a rising or falling market if speculative betting per se is right or wrong. To translate this issue directly into the domain of gambling: how can it be judged immoral to bet on black but moral to bet on red if either option is consistent with one's rational or irrational expectations?

Within economics, the upsides of speculation in general are often raised in arguments in favor of speculation. For instance, financial instruments such as options and futures allow individuals (e.g., farmers) to insure themselves against non-preferred outcomes (e.g., a bad harvest) if an investor is willing to take on the risk in exchange for a premium. Furthermore, speculation allows people to "put their money where their mouth is." Thus, information is aggregated "efficiently" because there are incentives to publicly display true beliefs about the future, which are then reflected in market prices.