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Escalation in Decision-Making

Behavioural Economics in Business

HELGA DRUMMOND
and JULIA HODGSON

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Liverpool
April 2010

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Introduction

It is afternoon on the market. Barrow boys are calling, 'Pick your own bananas! Twenty pence a pound! Come on now ladies! Pick your own bananas!' Another stall-holder shouts, 'Margarine! Plenty of margarine!' It starts raining. A trader grapples with plastic sheeting to protect his stock. His neighbour advises him not to bother. 'You can't damage damaged goods!' he jokes.

Anxiety lurks beneath the banter. Once, being a market trader was a sure route to prosperity, particularly on the indoor market where some traders became millionaires. 'Stalls were like gold dust,' said a trader. 'You couldn't get one for love nor money.'

Times have changed; January and February were known as 'kipper months' because of the quiet post-Christmas trading. Now almost every month is a 'kipper'. Gone are the days when flower sellers carried their takings home in buckets and spent all of Sunday counting out the copper and silver coins and when grocers could pile their counters high with pork pies and expect to be sold out by five o'clock. Now, hardly a week passes without another trader pulling down the shutters for good. Despite the poor prospects there is no shortage of new owners willing to 'give it a go'– sometimes taking a stall where the previous owner has just gone bankrupt. Most of these new hopefuls measure their tenure in months – sometimes only weeks. What makes them believe that they can succeed where others are so obviously failing?

Among the hardest hit were those who paid huge sums of money to acquire a business on the market when stalls were 'gold dust'. Among the last to arrive, they have frequently been the first to leave – particularly those who borrowed heavily to finance their expensive acquisitions. Yet no one is immune from the downturn. 'This stall is in a good position,' said Nana, a long-standing trader whom we shall meet later in this book, 'but what can you do when people aren't even stopping to look?'

Dangers of Escalation

What indeed? One of the most important decisions individuals and organizations may ever have to make is what to do when a venture falters. Do they cut their losses or do they reinvest and risk throwing 'good money after bad?' Economics teaches that market forces ultimately curb non-viable enterprises. The trouble is market forces can be slow to act. By the time it becomes plainly apparent that there is no hope of recovery, the damage may be well and truly done.

Yet behavioural theorists believe that decision-makers frequently make things worse for themselves by reinvesting in doomed enterprises – a phenomenon known as escalation of commitment. Escalation theory is important because it implies that many decision failures are avoidable. Individuals and organizations can learn to make better, that is, more economically sensible decisions.

There is certainly scope for better decision-making in both the public and the private sector. The UK's NHS electronic patient-record system is so far behind schedule that it seems destined never to appear, or if it does, will probably be obsolete by the time it goes into service. The London 2012 Olympic Games are well over budget. Yet despite the UK's precarious economic position, there is no question of cancelling the project. In 2000 Marks and Spencer (founded by Michael Marks from a stall on Leeds market) almost collapsed thanks to the company's persistence with an outmoded business model. Eight years later in 2008, Woolworths collapsed for similar reasons. In June 2009 National Express were forced to surrender the East Coast franchise, having failed to meet their hugely optimistic forecast of achieving a 10 per cent increase in passenger revenues. GNER had already failed to run the East Coast railway profitably – bankrupting the parent company Sea Containers in the process. As if one bad experience was not enough, in early 2010, National Express announced that they might bid again for the franchise! In 2010 Toyota suffered a huge loss in public confidence after being forced to recall of millions of cars with a potentially lethal fault in the accelerator. Recalls are actually quite common in the motor industry. If Toyota had acted earlier, instead of allowing the problem to fester, the company would have been spared much of the costly damage they eventually incurred.

Yet it is unclear what actually causes escalation. The main theories are explained later in this book. Suffice it here to note that part of the problem is that most of the research has involved experiments comprising paper and pencil tests that present decision-makers with reliable information and clear-cut choices – conditions seldom found in reality. In reality decisions must be made amidst the 'fog of war' where problems are often ill-structured and surrounded by ambiguity and uncertainty. Furthermore, whereas experiments demand instant decisions, in reality decision-makers can procrastinate – for a time at any rate.

Aims of the Book

This book has two main aims. One is to examine the relevance of the various theories of escalation to 'real-life' decision-making. The second is to draw lessons for practice. Indoor market traders were chosen as subjects to study escalation and de-escalation because they face economic extinction. Escalation theory is 'work in progress.' Each case in the present study is like a tiny piece of mosaic that contributes to the bigger picture.

Structure of this Book

The book is structured as follows. The main behavioural theories of escalation are explained in Chapter 1. The aim has been to present those theories in accessible language with examples from private and public sectors. This chapter also discusses some of the controversies surrounding escalation theory. Are decision-makers as reckless as behavioural theorists seem to imply? Or is escalation largely unavoidable, that is, just a normal business expense?

Chapter 2 takes the reader on a tour of an imaginary market. The purpose of this chapter is orientation. It sets the context for the research, by sketching some of the history of markets and the sights and sounds of a modern market.

According to behavioural theorists escalation typically starts with bright promises. Chapter 3 explores this proposition by analysing interviews with new traders. Assuming that no one starts a business intending to fail, what explains new traders' optimism when the odds are so heavily stacked against them? Also, why do experienced owners sometimes make obvious mistakes?

Not all new start-ups fail completely. Chapter 4 analyses interviews with traders who start new businesses that may not be completely successful but survive nevertheless. In each case the metaphorical bottle is simultaneously half-full and half-empty. Analysis focuses on how owners respond to such equivocal situations and why they may be tempted to escalate their commitment and risk overreaching themselves.

Chapter 5 focuses on established traders who persist with their failing business until forced to quit. Why did they not leave when they had the chance? Moreover, why do they keep the business open when persistence is only making things worse?

All theories are false because they are abstractions from the real world. Chapter 6 explores cases of traders who contradict extant theory by exiting sooner rather than later thereby capping their losses. What distinguishes them from those who remain to the bitter end?

Although not all established traders are in acute financial straits, persistence may be economically suboptimal nevertheless. Why do they not switch to more profitable lines of businesses or even change career altogether? Chapter 7 concerns another form of 'lock-in' known as entrapment. Whereas escalation results from a deliberate decision to reinvest resources in a failing venture, entrapment results mainly through the simple passage of time. Chapter 7 sketches the main theories of entrapment.

Chapter 8 examines the relevance of those theories by analysing cases of traders who have succumbed to 'lock-in'. The chapter includes a case that contradicts the theory. This outlier serves as a counterpoint to compare and contrast other cases. The focal question for analysis is what holds entrapped traders in place? Do they simply not realize what persistence is costing them, or is it because changing direction has become too costly?

Chapter 9 summarizes the main findings of the study. What do we now know about escalation and entrapment that we did not know before? The chapter begins with a resume of the main theories of escalation and entrapment and mentions some of the limitations of the research before addressing the central research questions. This chapter ends with suggestions for research.

Chapter 10 considers the implications for practice. The recommendations are aimed at both entrepreneurs *and* executives. This chapter includes a discussion of the role of options in limiting escalation and entrapment.

To preserve the narrative flow, the procedures used to obtain the data, conduct interviews, construct and analyse the cases and so forth are explained in a section entitled 'Note on Method' at the end of the book. It should be noted here, however, that names and contextual details have been changed to conceal owners' identities. Details concerning time and place have been kept vague for the same reason.

It is dangerous to try to summarize a complex and nuanced study into a few 'take-home' messages. Mindful of that caveat, the present study reveals that escalation and entrapment are by no means inevitable. If they do take hold, however, the results can be devastating. Decision-makers can best protect themselves by taking charge. That means reading the road ahead and erring on the side of caution by exiting sooner rather than later even though the cost may be high. The most dangerous response may be to live on borrowed time. Those who avoid painful decisions may end up facing an even bigger reckoning. On a more positive note, it is axiomatic that risk-taking is the key to generating wealth. In studying some traders it becomes apparent that the emotional behaviour which can produce bad decisions can also drive progress. There may be a fine line between success and calamity.

The Epilogue briefly reflects on one of the most successful gambles in business history.

A Note on Method

Discovery consists of seeing what everyone else has seen and thinking what no one else has thought.

(Albert von Szent-Gyorg)

The Role of Theory

The window nearest the north transept of the medieval church of St. Cross near Winchester is angled so that sunlight falls on the church cross on only two days of the year. Those days are 3 May, the day in the church calendar of the Invention of the Cross, and 14 September – Holy Cross Day. A theory explains and/or predicts something. The window at St. Cross is an enduring testimony to the genius of medieval astronomers. Without the aid of modern telescopes and computers, they could predict exactly where the sun would fall on two days of the year, although they were unable to explain why.

Theories are axiomatic systems of thought. More specifically, a theory may be defined as, 'A statement of relations among concepts within a set of boundary assumptions and constraints' (Bacharach 1989: 496). The role of a theoretical statement is to simplify the observed world by organizing parsimoniously and communicating clearly. Indeed, a good theory may make only one single prediction. For example, Festinger's (1957) influential dissonance theory predicts that people are motivated to resolve inconsistencies (Sutton and Staw 1995: 377 discusses this point).

Since they are abstractions, all social sciences theories are wrong by definition. Yet they can still be useful. Usefulness means that a theory changes how we think about things (Weick 1989). That said, the aim of the present study was not to generate new theory but to develop existing theory. Besides, completely new theories are rare as social scientists are inevitably influenced by what has gone before (for example, Bacharach 1989). More specifically, the present study pursues the middle ground as it examines the relevance of extant theorising and research and tries to fill gaps (for example, Pratt 2009: 859, Weick 1989).

More specifically, as the review of the extant theorising and research in Chapter 1 shows, researchers have already identified a long list of factors that are potentially conducive to escalation and entrapment. Thus, although the present study is concerned with *why* escalation and entrapment occur, the main scope for theoretical developments lies at the boundaries, that is, the *who, when, what* and *how* of escalation and entrapment. For example, what factors increase decision-makers susceptibility to escalation?

Why Case Studies?

Most research into escalation and entrapment has been conducted using experiments. Experiments have an important role to play, not least because they afford tight control over the variables studied. Yet that strength is also a limitation because so much depends upon the selection of variables in the first place. For instance, early experiments involving sunk costs found that the more money decision-makers had invested in a project, they more likely they were to persist (Garland 1990). Yet when the level of project completion was added to the equation, it became apparent that although sunk-costs may influence decisions about whether or not to persist with a faltering project, decision-makers are also influenced by how near the project is to being finished (for example, Conlon and Garland 1993, Moon 2001a).

In contrast, case studies allow the researcher to encapsulate a wide range of variables – including possibilities beyond extant theorising and research. More specifically, they allow researchers to probe decision-makers' perceptions, their emotions and to learn about contextual influences. Above all, case studies are grounded in reality. Experiments present decision-makers with hypothetical scenarios involving clear cut choices that can be made by merely ticking a box. Moreover, those choices are forced. Procrastination is not an option. Yet in reality, important decisions must be made amidst the 'fog of war' where issues are surrounded by ambiguity, uncertainty and 'noise'.

Why Market Traders?

Indoor market traders were chosen as study subjects because economic trends are driving many of them out of business and creating huge uncertainty for those who remain. Those who are being driven out of business have to decide whether to quit sooner rather than later. Those who are still viable but have seen trade decline, must also decide whether or not to persist with an economically suboptimal venture. These are precisely the issues that occupy escalation theorists.

Why Multiple Case Studies?

The development of escalation theory is like building a mosaic, whereby each study contributes another tiny piece towards a bigger picture (Weick 1989). The rationale for selecting cases in the present study is that each one contributes something (a piece of mosaic) to our knowledge and understanding of escalation and entrapment.

In more formal language, multiple case studies can be useful in elaborating theory, 'By piecing together the individual patterns the researcher can draw a more complete theoretical picture' (Eisenhardt 1991: 620). Emphatically, the present study is not a statistical survey and therefore it is impossible to generalize from the results. The criterion for selection of cases centres upon theoretical or as it sometimes called, purposive sampling (Glaser and Strauss 1968). That is, cases have been selected for analysis because they have something new to say about escalation and/or entrapment. 'New' means that a case either validates (or contradicts) existing theory and research, and/or offers new insight. There is no hard and fast rule about how many to include. To paraphrase Eisenhardt (1991: 622), that depends upon what is already known and what a new case can add.

Research stops when theoretical saturation is reached. In other words, when successive cases add little or nothing to what is already known about a particular phenomenon. In practice, true theoretical saturation is seldom achieved because there is always something new to be learned. Yet as the present study progressed, certain themes began to be being repeated suggesting that the research was approaching a kind of saturation. For example, interviews with new traders whose businesses failed pointed repeatedly to insufficient reality testing.

Not all interviews are reported in this book. More specifically, if an interview merely raised the same issues as another interview, there is no point in including it because it adds nothing new. Where there is little to choose between cases, the one that offers the richest and most interesting contextual detail has been selected.

Approach to Interviewing

New traders were mainly identified by public notices announcing a new tenancy, or sometimes by observation – seeing a new trader in situ. Established traders were identified from indicators such as 'closing down' sales, a 'to let' sign over the door or a notice saying 'business for sale' sign or signs of distress such as stocks running very low or an owner doing very little business.

Most of the interviews were conducted by the first author. The second author made visits to the research sites and conducted some interviews and informal conversations as a familiarization exercise. Requests for an interview were usually made in person. Some approaches were made by telephone, for example, if the owner did not actually work in the business or if the business was boarded up but the owner's telephone number was still visible.

If the owner agreed to be interviewed, there would normally be preliminary exploration of their history and present circumstances followed by a full interview. (Sometimes the first stage had to be dispensed with as the owner would invite the researcher to start the interview there and then.) The purpose of the initial exploration was to seek background information to inform the interview. For example:

H.D.: You said on the phone that it had been a hard decision to come out. Why is that?

Barry: Because when this one (shop) goes ... I am no longer self-employed. I am no longer my own boss.

The focal 'decisions' of interest in each case are the decision to open a business on an indoor market and, subsequently either close it down or reinvest in it when expectations are not being met. Or, it means a decision by an established trader either to close down a business or persist with it suboptimally. The unit of analysis in each case is the registered owner of the business.

All interviews were approached in a semi-structured fashion. A list of questions (see Table M.1) was used to guide the interview with supplementary questions to probe emergent issues. Owners were also encouraged to talk about what was important to them.

Table M.1 Interview schedule

1. Please tell me something about yourself.
2. Is this your first business?
3. How did you come to open it?
4. How long have you owned it?
5. Do you own any other businesses?
6. Are you the sole owner?
7. Why did you go into business?
8. How well did you know the market before deciding to open?
9. Why did you decide to sell, clothes/food/etc. as applicable?
10. How have you been able to finance your start-up?
11. Did you have a business plan?
12. What made you believe you would succeed?
13. What risks did you think you were taking?
14. What risks do you see now?
15. Can you give me an idea of what your outgoings are?
16. How is the business doing?
17. Is that better or worse than expected?
18. Have you had to put extra money into it?
19. How long you are prepared to persist with the business?
20. Are you able to draw a wage/salary from the business?
21. How do you feel about the business now?
22. What do you think you will do next?
23. What are you hoping to achieve in the longer term?

If applicable:

24. When did the business begin to decline?
25. How did you become aware of the decline?
26. How did you react to it?
27. Did you ever think of making changes to the business before it declined?
28. If so, what changes and with what result?
29. If not, why not?
30. What happened next?
31. Have you tried to sell the business?
32. Have you set any limits on how long you will keep the business?
33. What is it costing you to keep it open?
34. Why do you keep it open?
35. What made you decide to close the business?
36. Could you have closed it sooner?
37. If not, why not?
38. How do you feel the decision?
39. How easy or hard was it for you to make the decision?
40. Have you any alternative employment (or other option)?

All interviews were tape-recorded (latterly electronically recorded) and transcripts produced. Interviews ranged from 40 minutes to over 3 hours, generating anything up 60 pages of transcript. Quality should not be confused with quality. Long interviews were not necessarily more informative than short ones. Owners who gave longer interviews might repeat themselves or talk at length about the intricacies of their line of business. Some of this contextual detail is reproduced in the text as it adds colour and variety to the text, even though it is not strictly relevant to the subject matter. Owner's sometimes say 'we' when they mean 'I'. The original has been left to stand.

Owners chose the interview location. Some interviews were conducted in the owner's home, some in nearby cafes and others actually at the stall itself with the researcher variously perched on a spare stool, a box or a pile of carpet. One participant who had forgotten the appointment invited the researcher to conduct the interview from behind the counter while they served customers. One interview was held in a fish van. Owners might be interviewed more than once as the researcher tracked their progress.

Approach to Analysis

Eisenhardt (1989, 1991) urges researchers to start from clear constructs and testable propositions. In contrast, Dyer and Wilkins (1991: 634) argue that story is all-important for developing theory: 'Good story telling is what makes the most difference in the generative capacity of ... studies,' they say.

The present study takes its leads from Dyer and Wilkins. The emphasis is upon presenting data holistically in order to further our understanding of the contextual realities and pressures of escalation and entrapment.

A case study is essentially a story, albeit told in a systematic fashion. The task of analysis proceeded as follows. Each transcript was summarized by the first author. The summarized version omitted extraneous material and repetition. Analysis proceeded using the summarized transcript but referring back to the original to retain a holistic perspective.

Theory determines what we see and how we see (for example, Glaser and Strauss 1968, Wicker 1985, Weick 1989). Ideally, analysis should ignore existing theories and research. In practice this is impossible, so a two-stage approach was used. Stage one involved analysing the data within the confines of escalation literature. Stage two involved stepping outside it.

To be more precise, stage one involved cycling back and forth between data and theory (Glaser and Stauss 1968) looking for 'goodness of fit' between the two. To guide the process, a list of pointers (see Table M.2) was compiled from the extant literature.

Stage two involved re-visiting transcripts to see what had been missed with a view to teasing out additional insights. This exercise revealed factors that are not prominent in the literature but are potentially relevant to explaining escalation and entrapment – for example, the impact of owners' prior commitment and subsequent disappointment in producing risk-seeking behaviour (for example, Anita), lowering expectations as a passive form of reinvestment (for example, Tony) and issues of decision-avoidance (for example, Carole).

In order to try to overcome the blinkered approach imposed by extant theory and research, 'playful' techniques of 'disciplined imagination' (Weick 1989, Mills 1959) were

Table M.2 Pointers for analysis derived from extant literature

- Alternatives (e.g., McCain 1986)
- Commitment (e.g., Salancik 1977)
- De-escalation – possible premature (e.g., Drummond 2005)
- Denial (e.g., Staw and Ross 1987a,b)
- Depression (e.g., Moon et al. 2003)
- Ego defensiveness (e.g., Staw 1981)
- Entrapment (e.g., Rubin and Brockner 1975)
- Escalation (e.g., Staw 1976)
- Experience (e.g., Langer 1983)
- Feedback: positive, negative, equivocal (e.g., Bowen 1987)
- Learning (e.g., Singer and Singer 1985)
- Loss (e.g., Whyte 1986)
- Limit setting (e.g., Simonson and Staw 1992)
- Myopia (e.g., Simons and Chabris 1999)
- Opportunity cost (e.g., Northcraft and Neale 1986)
- Options (e.g., Zardkoohi 2004)
- Overconfident (e.g., Taylor 1980)
- Prospect theory (e.g., Whyte 1991a,b)
- Quitting points (e.g., Simonson and Staw 1992)
- Rationality: prospective, retrospective (e.g., Staw and Ross 1978)
- Reference point (e.g., Whyte 1986)
- Relative magnitudes (e.g., Kahneman and Tversky 1982)
- Reinvestment: active, passive (e.g., Brockner, Shaw and Rubin 1979)
- Risk propensity (e.g., Sitkin and Weingart 1995)
- Risk perception (e.g., Wong 2005)
- Risk-seeking (e.g., Whyte 1991a,b)
- Salvage value (e.g., Staw 1997)
- Self-enhancement (e.g., Pfeffer and Fong 2005)
- Side bets (Becker 1960)
- Social pressure (e.g., Teger 1980)
- Sudden shock (e.g., Ross and Staw 1993)
- Sunk costs (Arkes and Blumer 1985)
- Time investment thereof (e.g., Coleman 2009)
- Vividness (e.g., Bazerman and Watkins 2008)
- Waste (e.g., Arkes 1996)

deployed. For example, what would be required for a perfect relationship to exist between two variables such as alternatives and de-escalation (Wicker 1985)?

To give an example of how this approach worked, Terry reinvested his entire life savings to maintain a failing business. Yet Carole, who had also spent her whole life on the market and might therefore have been expected to have been highly vulnerable to escalation, exited with her savings largely intact. Both recognized that persistence was hopeless: Carole when she had no surplus to invest, Terry when Christmas trade failed. How could this apparent conundrum be explained? Deploying Mill's technique of inverting the sense of perspective, in this case imagining near things as far and vice versa, it became obvious that what separated the two was time. To coin a cliché, Carole saw the future just before it had arrived, Terry only after it had arrived. This insight then led on to the role critical incidents could play in limiting escalation. Another playful technique was to deploy so called 'thought trials', that is, mental experiments (Weick 1989). One form of mental experiment deployed in the present study was to study the opposite of escalation and entrapment such as Mike's risky decision to completely revamp his businesses.

Reporting Protocols

The main aims in presenting the data were to reflect the world view of participants and to share as much as possible with the reader to enable them to judge the adequacy of interpretations reached. Inevitably this approach means some repetition and cross-referencing of cases. For example, some themes such as sunk costs and 'side-bets' repeat themselves across several cases.

To protect participants' identities, all names have been changed. Likewise, time and place have been deliberately obscured. Contextual details have also been changed where they do not affect the story. Where it is necessary to preserve those details, additional precautions have been taken to protect the participants' identity. Quotations are reproduced in participants' own words except for some minor editing to facilitate comprehension.

Researchers and Researched

None of the participants in the present study were known to us previously. No attempt was made to engage in participant observation, for example, by working on a market stall.

The first task on visiting a market hall was to gauge 'the mood of the market'. This not a recognized social sciences technique! It refers to an intuition about when to make an approach and (most importantly) when not to, as a clumsy or ill-timed opening could jeopardize the chance of being granted an interview. If the 'mood' did not seem right, no approaches were made and the researcher would return empty-handed. Experience, moreover, taught that Fridays and Saturdays were 'out' as regards holding interviews or even conducting informal conversations as most traders were too busy attending to customers. First thing in the morning was not a good time either; nor was late in the day. Traders were either busy setting out their stalls or packing them up. The best time to approach was early in the week, just after two o'clock in the afternoon. By then the lunch time rush had usually died down, aisles emptied, and with two hours to go before 'packing up' time, many traders were only too glad to speak. Another quiet time was on a Tuesday or Wednesday morning if it was half-day closing. A few new owners were too busy setting up their shops to participate in the research. A few new owners disappeared before they could be interviewed. One established trader leaving the market was too upset to be interviewed. Another was too engrossed in a book. Only one said 'Mind your own business.'