

Nonrational Escalation of Commitment in Negotiation

MAX BAZERMAN, J. Jay Distinguished Professor of Dispute Resolution and Organizations, J.L. Kellogg Graduate School of Management, Northwestern University, USA; MARGARET NEALE, J.L. and Helen Kellogg Distinguished Professor of Dispute Resolution and Organizations, J.L. Kellogg Graduate School of Management, Northwestern University, USA.

In business, as in other forms of human activity, negotiators can fall into traps and make choices and behave in ways which act against their own self-interest and that of the organizations they represent — sometimes with catastrophic consequences.

A common trap is that of nonrationally escalating a

commitment to a previous course of action. Giving case studies in America of such events, Max Bazerman and Margaret Neale identify three critical psychological motives for managers (and others) to escalate initial commitments into a competitive spiral that can ultimately be very damaging. Such escalation can even occur without competition.

People often make choices and behave in ways that are not consistent with their own self-interests. This is particularly true when we consider much of the behavior of negotiators. One common mistake that negotiators and others make is that they nonrationally escalate their commitment to a previous course of action. Consider the following three cases.

The Campeau-Federated Merger

In 1987, Robert Campeau, then featured in *Fortune's* 'Fifty Most Interesting Business People', was seeking to acquire retail establishments both for their property value and their drawing power for malls that he planned to build across the US. To implement this strategy, Campeau focused on the nation's most profitable department store, Bloomingdale's. Campeau initiated a hostile takeover bid for the Bloomingdale's parent company, Federated Department Stores, on 25 January 1988.

In the months that followed, a highly public bidding war developed between Campeau and Macy's over what was to become the largest and most visible retail merger in history. By 25 March, *The Wall Street Journal* (3/25/88) observed that 'we're not dealing in price anymore but egos. What's been offered is top dollar, and beyond what anyone expected'. In the meantime, industry executives asserted that the prolonged battle was decreasing the value of Federated as managers defected, and confusion existed concerning purchases of fall merchandise and expenditures for seasonal promotions (*The Wall Street Journal*, 3/25/88).

On 31 March, with Macy's on the verge of winning the bidding war, Campeau approached Macy's with an eleventh-hour offer to cede victory if Macy's would sell



him Bloomingdale's and Burdines (Lampert, 1988). Such a settlement would have provided Campeau with a face saving exit strategy. Macy's refused! Campeau escalated by topping Macy's already high offer by roughly \$500 million. Analysts viewed Campeau's action as unjustified based on a rational assessment of the situation. He won the battle, but lost the war. In January 1990, Campeau declared bankruptcy. Campeau greatly overpaid for Federated, and this irrational generosity caused the downfall of his organization.

This basic story has been repeated across many merger situations. Once a visible figure has his or her sights set on a particular target, the desire to 'win' at any cost can force out rationality in developing a negotiation strategy. This egocentric motivation provides one reason why acquirers have failed, in the aggregate, to make money in the merger-and-acquisition process. While many experts argue that synergy is created in the merger process, such benefits are one-sided. The value of the synergy has gone to the targets, not to the acquirers (Rapaport, 1986).

The Coffee Wars

America's two largest coffee brands, Phillip Morris' Maxwell House and Procter and Gamble's Folgers, have been battling for over ten years for the dominant share of the US coffee market. They have used price-cutting, advertising (including hostile, competitive advertisements), and tens of millions of cents-off coupons as weapons in this war. Both companies spent \$100 million on coffee advertising in 1990, roughly four times what was spent only three years ago.

This escalatory action has created major problems for the industry. The American consumer now pays an average of just 3.5 cents for a serving of coffee, a depressed price that hurts all firms in the industry. Despite the erosion of profitability and the large expense of the competition, neither Maxwell House nor Folgers has significantly improved its market share during this period.

Competition of this type is common. We could replace the story of the coffee wars with a story of the cola wars (Pepsi/Coke), or the camera wars (Polaroid/Kodak), and the story would not change substantially. In these cases, each side views its goal as beating the other firm. An alternative approach is 'how can the industry be more profitable?' It is very common for competitors to simply continue an irrational escalation, rather than developing a way of cooperating.

Bobby Knight Takes on the Soviet Union

The two examples above have focused on complex, multi-million dollar negotiations. However, the effects of escalation also permeate routine managerial behaviors, financial decision making, and athletic competition.

One such example concerns Bobby Knight and the Soviet Union.

In 1987, Indiana University played an exhibition game against the Soviet Union. In the middle of the game, Indiana Coach Bobby Knight had a heated debate with a referee. In accordance with international rules, the referee asked Knight to leave the game and to return to the locker room. Knight resisted and said that if he had to go, so would his team. The referee asked if that decision was final and, when Knight said 'yes', the game was declared a forfeit. Knight was appropriately criticized in the media and the outcome was an embarrassment to Knight, the Indiana team, Indiana University, amateur competition, and the United States.

All parties would have fared better if Knight had simply left the court and allowed an assistant coach to assume coaching responsibilities. However, Knight, like many managers, escalated the conflict rather than accepting defeat. Many of us tend to escalate conflict in order to save face and justify an earlier course of action.

In each of these cases, the information existed for the party to rationally pursue an end to a conflict. Our knowledge of the escalation process, however, accurately predicts the catastrophes that followed — Campeau went bankrupt, the coffee makers continue to lose millions of dollars in opportunity costs, and Knight embarrassed himself and all the constituencies that he represented. In each case, an initial loss led to a further escalation of the party's commitment to a previous course of action.

Although each of the three negotiations above represents a very different situation, they share a number of elements in common. In each case, the decision maker has made a previous decision to follow a particular course of action. In each case, the decision maker has invested a great deal of time, effort and/or resources in a selected course of action which did not yield an optimal outcome. In each case, the carrot that made continuing so attractive was the perceived possibility (with a typically small probability) that escalating the conflict one step further could lead to victory.

A key to making rational decisions in negotiation is being able to discriminate situations in which persistence will pay off from situations in which it will be counterproductive. Misdirected persistence can lead to wasting a great deal of time, energy and money (Tyler and Hastie, 1991). However, directed persistence can lead to commensurate payoffs. After all, we are taught from an early age the value of the motto, 'try, try, again'.

We define *nonrational escalation* as the degree to which an individual escalates commitment to a previously selected course of action to a point beyond that which rational analysis would recommend. Rational negotiation requires that we recognize that the time and/or expenses already invested are 'sunk costs'. That is, these costs are historical costs that are *not* recoverable and

should *not* be considered in any future course of action. Our reference point for action should be our current state, and we should consider all alternative courses of action by evaluating only the *future* costs and benefits associated with each alternative.

While rational decision making would lead us to evaluate the future benefits and costs of alternative actions, observation of managerial behavior and systematic research shows that managers do not ignore sunk costs, and participating in executive training or having an MBA does not change this basic conclusion. Why, then, is it so hard for managers to absorb the sunk cost concept in a lasting manner?

Psychologists have demonstrated that decision makers who commit themselves to a particular course of action have a tendency to make subsequent decisions that continue that commitment beyond the level that rationality would suggest is reasonable. As a consequence, resources are often allocated in a way that justifies previous commitments, whether or not those initial commitments now appear valid (Bazerman, Giuliano and Appleman, 1984; Brockner and Rubin, 1985; Staw, 1976, 1981; Teger, 1980).

Our studies have found that the tendency to escalate generalizes from financial and military situations to common day-to-day experiences in managerial life (Bazerman, Beekun and Schoorman, 1982; Schoorman, 1988). For example, individuals who made an initial decision to hire an employee subsequently negotiated harder in the interest of that employee, evaluated that employee more favorably, provided larger rewards and made more optimistic projections of future performance than did individuals who did not make the initial decision to hire the employee.

The \$20 Bill Auction

In the following scenario, we ask that you imagine yourself in a room with 30 other individuals and the person at the front of the room takes a \$20 bill from his/her pocket and announces the following:

I am about to auction off this \$20 bill. You are free to participate or just watch the bidding of others. People will be invited to call out bids in multiples of 1 dollar until no further bidding occurs; at which point the highest bidder will pay the amount bid and win the \$20. The only feature that distinguishes this auction from traditional auctions is a rule that the second highest bidder must also pay the amount he/she bid, although he/she will obviously not win the \$20. For example, if Bill bid \$3 and Jane bid \$4, and bidding stopped, I would pay Jane \$16 ($\$20 - \4) and Bill, the second highest bidder, would pay me \$3.

Would you be willing to bid \$1 to start the auction? (Make this decision before reading further.)

We have run this auction with investment bankers, consultants, professors, partners in Big Six accounting firms, lawyers and assorted other executives. The early pattern is always the same. The bidding starts out fast and furious until the bidding reaches the \$12 to \$16 range. At this point, everyone except the two highest bidders drops out of the action. The two bidders then begin to feel the trap. One bidder has bid \$16 and the other \$17. The \$16 bidder must either bid \$18 or suffer a \$16 loss. The uncertain option of bidding further (a choice that might produce a gain if the other guy quits) seems more attractive than the current sure loss, so he/she bids \$18. This continues until the bids are \$19 and \$20. Surprisingly, the decision to bid \$21 is very similar to all previous decisions — you can accept a \$19 loss or continue and reduce your loss if the other guy quits. Of course, the rest of the group roars with laughter when the bidding goes over \$20 — which it virtually always does. Obviously, the bidders are acting irrationally. But what are the irrational bids?

Sceptical readers should try out the auction on their friends, co-workers or students. It is very common to have final bids in the \$30–\$70 range, and our most successful auction sold a \$20 bill for \$407 (the final bids were \$204 and \$203). In total, we have earned over \$10,000 running these auctions in classes over the last four years.

The dollar auction paradigm was first introduced by Martin Shubik (Shubik, 1971). The task has been used to understand why individuals escalate their commitment to a previously selected course of action (Teger, 1980). Participants naively enter the auction not expecting the bidding to exceed the true value of the object (\$20) — 'After all, who would bid more than \$20 for \$20?' The potential gain, coupled with the possibility of 'winning' the auction, are enough reason to enter the auction. Once the subject is in the auction, it takes only a few extra dollars to stay in the auction rather than accept a sure loss. This 'reasoning', along with a strong need to justify why the bidder entered the auction to begin with, are enough to keep most bidders bidding for an extended period of time.

Thoughtful examination of the dollar auction game suggests that individuals who bid create a problem for themselves. It is true that one more bid may get the other guy to quit. However, if both bidders feel this way, the result can be catastrophic. Yet, without knowing the expected bidding patterns of the opponent, we cannot conclude that continued bidding is clearly wrong. So what is the bidder's solution? Successful decision makers must learn to identify traps, and the key to the problem lies in identifying the auction as a trap and never making even a very small bid. One cognitive strategy for identifying competitive traps is to try to consider the decision from the perspective of the other decision maker(s). In the dollar auction, this strategy would quickly tell you that the auction looks just as attractive to other bidders as it does to you. With this knowledge, you can accurately predict what will occur and stay out of the auction.

We can find similar traps in business, war and our personal lives. The Vietnam War was a clear application of the dollar auction paradigm. Similarly, it could be argued that in the Iraqi/Kuwait conflict, Iraq (Hussein) had the information necessary to rationally pursue a negotiated settlement. In fact, early on in the crisis, he was offered a package for settlement that was far better than anything that he could have expected through a continued conflict. The escalation literature accurately predicts that the initial 'investment' incurred in invading Kuwait would lead Iraq to a further escalation of its commitment not to compromise on the return of Kuwait.

Successful decision makers avoid escalation behaviour by identifying competitive traps

Two gasoline stations staging a price war can also result in the dollar auction trap. The price of gasoline is \$1.50/gallon. Your competitor decides to drive you out of business. You would also like to drive them out of business. They drop the price to \$1.45/gallon. You drop the price to \$1.40/gallon — your break-even point. They drop their price to \$1.35/gallon. What's your next move? Both parties may suffer tremendous costs in an effort to win the price war and, like the dollar auction, neither side is likely to actually win the competition based on price alone.

Why Does Escalation Occur?

Eliminating nonrational escalation requires that we be able to identify the psychological factors that feed escalation behavior. The three critical causes for our tendency to escalate commitment are that when we make an initial commitment to a course of action, commitment:

1. biases our perception and judgement,
2. leads us to make irrational decisions to manage the impressions of others, and
3. leads to a competitive escalatory spiral.

Each of these three effects is discussed below.

Biases in Perception and Judgement

Once Campeau decided to try and acquire Federated, his perception is likely to have been biased in favor of observing data that supported this initial decision, and not perceiving data that contradicted his initial decision. Most of us seek and readily accept confirmatory evidence and ignore disconfirming information. It is easy to identify the confirmation trap in your decision process. You make a tentative decision (e.g. to buy a new car, to hire a particular employee, to start research and development on a new product line). Do you search for data which supports your decision before making the final commitment? Most of us do. It is easy to see that once a negotiator commits to a basic strategy, he/she is likely to be biased in favor of the data that is consistent with the initial decision.

Similarly, managers often protect their initial decisions by actively seeking out information that supports these decisions (Caldwell and O'Reilly, 1982) — e.g. information that suggests that Campeau's selection of this acquisition target made sense. Individuals who freely choose a particular course of action subsequently filter information selectively to justify commitment to that course of action (Caldwell and O'Reilly, 1982).

The perceptual biases that result after we make a commitment to a particular course of action suggest a number of corrective procedures. We need to search vigilantly for disconfirming information, as well as the confirming information which we intuitively seek. This need is particularly pronounced in serial decisions where we have a natural tendency toward escalation. In addition, establishing monitoring systems that help us check our perceptions before a subsequent judgement or decision is made could prove useful. For instance, if an objective outsider could facilitate our search for and openness to disconfirming information, a major perceptual barrier to more rational behavior could be reduced or eliminated.

The above paragraphs have dealt with how an initial commitment will bias the information that the negotiator perceives. In addition, the initial commitment will bias the judgements that the negotiator makes based on his/her perception of the information. That is, the negotiator will tend to form expectations about the future that will justify judgements consistent with his/her initial course of action. Any loss from an initial investment (e.g. bidding over \$20 in the \$20 bill auction) will systematically distort judgement in favor of continuing to bid. Thus, Campeau's judgement about the future of the merged company is likely to have been positively biased to justify the decision that he was following.

Impression Management

Even if Campeau knew that Federated was no longer worth the necessary acquisition price, he had the problem of his reputation with his critical stakeholders. To lose to Macy's may have been unacceptable in terms of the impression that he was trying to convey to others. Individuals not only perceive information selectively, but they also provide information to others selectively. Specifically, individuals who make an initial commitment to a particular course of action are more likely to provide confirming, rather than disconfirming, information to others. Campeau may have been motivated to provide his stakeholders with additional information implying the rationality of his acquisition strategy.

In addition to not wanting to admit failure to others, we are also motivated to try to appear consistent, and the consistent course of action is to increase our commitment to our previous actions. The notion of consistency is strongly reinforced today in society, organizational and personal interactions. Barry Staw and Jerry Ross argue that our society perceives that leaders who are consistent in their actions are better leaders than those

who switch from one line of behavior to another (Staw and Ross, 1980). Inconsistency was cited as the second most common reason for dissatisfaction with Carter in the Gallup Poll collected after Carter's first year in office (Staw, 1981). Similarly, in John F. Kennedy's book, *Profiles in Courage*, he suggests that one of the most courageous decisions politicians ever have to make concerns favoring an action that they believe to be in the best interests of the constituency, yet that they know will be disfavored by that very same constituency. As the above findings suggest, that conflict is particularly severe if this action consists of turning one's back on a previously supported direction.

Thus, an interesting paradox results: to make the best choice suggests making the best decision for your organization based on future costs and benefits — ignoring any previous commitments. Yet, you may be more likely to be rewarded for escalating your commitment to previously selected courses of action. From an organizational standpoint, this suggests that we need to create systems that reward good decision making over managing impressions. First, managers must convey throughout the organization that impression management at the expense of high quality decisions within the firm will not be tolerated. Second, organizations should strive to make the employees' values closer to those of the organization through reward systems. The organization wants the best decision. The manager wants to make the decision that will be best for managing his/her future career.

The view expressed in the above paragraph, that decisions should be evaluated based on process rather than outcome, is consistent with Peters' and Waterman's discussion of Heinz's experimentation with 'perfect failures' (Peters and Waterman, 1982). The perfect failure concept recognizes that many decisions are inherently risky. In fact, Peters and Waterman suggest that management recognize the learning that is acquired through failures and celebrate when failures occur! The central point that Peters and Waterman convey to the managerial world is that we must recognize good choices, not just good outcomes.

Competitive Irrationality

Competitive irrationality refers to a situation in which two parties engage in an activity that is clearly irrational in terms of the expected outcomes to both sides, yet in which it is hard to identify specific irrational actions by either party. Many people would argue that getting involved in the \$20 auction is irrational and, while this is a very reasonable perspective, the argument is not completely valid. If it makes sense for you not to play, then it does not make sense for anyone else to play. If no one else plays, you can bid a small amount and get a bargain. This reasoning sounds logical, but once you make the initial bid, another individual bids, and the bind that we have already described appears.

We argued earlier that continuing to bid will then

depend on your estimation of the likelihood of the other party quitting. Obviously, the same reasoning applies to the other party. If it is possible for someone to get a very cheap \$20 (e.g. for \$1), it must be rational for one individual to be able to bid. Yet we know what happens when multiple individuals adopt this attitude. Thus, in many ways, competitive irrationality presents an unresolved paradox, rather than an explanation of escalation. One conclusion that can be derived from the competitive irrationality explanation of escalation is that many situations may appear to be opportunities but prove to be traps unless the range of actions of others are fully considered.

Final Comments

Escalation can occur without competition. For example, individuals making initial investment decisions are likely to make future decisions consistent with past decisions to justify their earlier decisions (Bazerman, Beekun and Schoorman, 1982; Bazerman, Giuliano and Appleman, 1984; Brockner and Rubin, 1985; Schoorman, 1988; Staw and Ross, 1978; Teger, 1980). Typically, this research compares the current decisions of participants who were responsible for an initial decision to another group that inherits the latter decision from a previous decision maker. Both groups are then asked to make a decision whether to commit further resources to the group initially chosen (i.e. to the course of action previously selected).

Note

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MAX BAZERMAN, J.L.
Kellogg Graduate School of Management, Northwestern University, Leverone Hall, 2001 Sheridan Road, Evanston, Illinois, 60208-2011, USA

Max H. Bazerman is the J. Jay Gerber Distinguished Professor of Dispute Resolution and Organizations at the J.L. Kellogg Graduate School of

Management at Northwestern University. He has a BSE from the Wharton School at the University of Pennsylvania and an MS and PhD from the Graduate School of Industrial Administration at Carnegie-Mellon University. Before taking his position at Northwestern University, Professor Bazerman was on the faculty of the Sloan School of Management at MIT, Boston University, and the University of Texas. Professor Bazerman is the author or co-author of over 70 articles on decision making and negotiation, the co-editor of *Negotiating in Organizations and Research on Negotiations in Organizations (Volumes 1, 2 & 3)*, and the author of *Judgment in Managerial Decision Making (now in its second edition)*, *Cognition and Rationality in Negotiation (with M.A. Neale)*, and *Negotiating Rationally (with M.A. Neale)*.



MARGARET NEALE, J.L.
Kellogg Graduate School of Management, Northwestern University, Leverone Hall, 2001 Sheridan Road, Evanston, Illinois, 60208-2011, USA

Margaret A. Neale is the J.L. and Helen Kellogg Distinguished Professor of Dispute Resolution and Organizations at the J.L. Kellogg Graduate School of

Management at Northwestern University. She received her BSP from Northeast Louisiana University, an MS degree from the Medical College of Virginia, an MS from Virginia Commonwealth University, and a PhD from the Graduate School of Business at the University of Texas. Prior to her position at Northwestern University, Professor Neale was on the faculty of the College of Business and Public Administration at the University of Arizona. She is the author or co-author of over 60 articles on negotiation and decision making as well as the co-author of three books: *Organizational Behavior: The Management Challenge (with G.B. Northcraft)*, *Cognition and Rationality in Negotiation (with M.H. Bazerman)*, and *Negotiating Rationally (with M.H. Bazerman)*.