

Judgment & Decision Making

Are People Rational?

Alison R. Fragale

**Kenan-Flagler Business School
University of North Carolina**



The Rules of the \$20 Auction



- Bids start at \$1; increase in \$1 increments
- No bidder can make two consecutive bids
- No talking except for bidding!
- Highest bidder pays what he/she bid & receives \$20
- Second highest bidder pays what he/she bid, receives nothing



Auction Observations

- Those that weren't involved in bidding war
 - How can you explain the behavior of your peers?
- The “winner” and “loser”
 - Are the observers' comments right?
 - What were you thinking and feeling?
- Highest I've seen: \$250
- Highest I've heard of: ~\$2000



The Beneficiaries of Your Misfortune

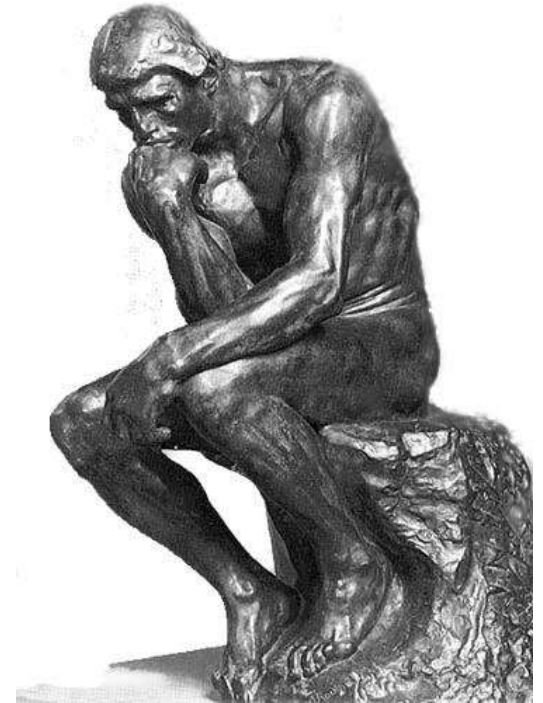


Was Your Behavior Rational?

- Escalation of commitment
 - Resources committed to initial course of action
 - Does not produce desired return
 - Commit more resources to “turn things around” and recover initial investment
 - Cost of failure increases
 - More resources are invested
- “Sunk cost bias”
 - Violates economic assumption of rationality

Rationality Reconsidered

The capacity of the human mind for formulating and solving complex problems is very small compared with the size of problems whose solution is required for objectively rational behavior in the real world.



Herbert Simon, *1978 Nobel Prize in Economics*



Rational Model of Decision Making/Problem Solving

Steps in the rational decision model

- Clearly define problem (gap between “what is” and “what ought to be”)
- Gather all relevant information, including alternatives
- Identify evaluation criteria
- Weight criteria given goals
- Evaluate each alternative on each criterion
- Select alternative that maximizes criteria



Real-Life Decision-Making is Not Rational

Rational Model Assumptions

We consider all alternatives and compare their probable outcomes

We use absolute standards and factual information to evaluate and choose alternatives

We evaluate all alternatives simultaneously and choose the one with the highest payoff

Organizational Evidence

We have limited information-processing capabilities, and only consider a small set of alternatives

We have an implicit favorite and process “facts” in different ways

We evaluate alternatives sequentially and choose the one that is “good enough”



Escalation is More Likely When

Project features encourage it

- Prospects of future gains still look bright

Psychological factors encourage it

- You overestimate your abilities to turn it around
- You fail to consider the responses of your competitors

Social factors encourage it

- You freely entered the project at the beginning (no coercion)
- You're accountable— you've publicly committed to the project
 - Emotional investment and concern for reputation

Structural factors encourage it

- Focus on sunk rather than opportunity costs
- You've made a large investment – stopping is costly

Escalation in Vietnam

“Once large numbers of U.S. troops are committed to direct combat, they will begin to take heavy casualties in a war they are ill-equipped to fight... Once we suffer large casualties, we will have started a well-nigh irreversible process. Our involvement will be so great that we cannot -- without national humiliation -- stop short of achieving our complete objectives. Of the two possibilities I think humiliation will be more likely than the achievement of our objectives -- even after we have paid terrible costs.”



George Ball, Undersecretary of State, in a 1965 letter to U.S. President Lyndon Johnson



Escalation is Everywhere

More examples

- Auctions (\$20, Ebay)
- Debt and equity financing
- Bad relationships



Research shows...

- People tend to allocate more money to failing projects & divisions than successful ones
- Especially when they are personally responsible for the original investment decision

Irrationality is Unconscious, Too

- People's decisions are also shaped by factors outside of their conscious awareness
- Example
 - Psychologist arranges for 2nd copy machine in a busy university library to break down
 - Long line forms for the only copy machine
 - Student makes a request to cut to the front of the line
 - Simple hypothesis: giving a reason will increase chances that people agree



The Obvious Result

Compliance Rate

(a) “Excuse me, may I use this Xerox machine?” **60%**

(b) “Excuse me, may I use this Xerox machine, because I’m late to class?” **94%**

- The implication
 - Rationally, just as you’d expect, people are more likely to decide “yes” when given a reason

The Surprising Result

- A third form of request
 - Follows the *structure* of the reason request, but provides no new information (a bogus reason)

Compliance Rate

- | | |
|---|-----|
| (a) “Excuse me, may I use this Xerox machine?” | 60% |
| (b) “Excuse me, may I use this Xerox machine, because I’m late to class?” | 94% |
| (c) Excuse me, may I use this Xerox machine, because I have to make some copies?” | 93% |

The Revised Implication

- Irrationally, even though you might not expect it...
 - People are more likely to agree to your request when given a reason, whether it's a real reason or not
- Mindless decision-making at work and in everyday life
 - “The lights are on but nobody's home”
 - “I was on autopilot”
 - “What was I thinking?”



A More Shocking Example

- Implicit egotism
 - We tend to make decisions that unconsciously remind us of ourselves
 - Research shows that people are attracted to places that resemble their own names
 - If your name is Jack, you're *4 times* as likely as a Phillip to live in Jacksonville, even though the two names are equally common
 - The Phils have retreated to Philadelphia, where they significantly outnumber the Jacks



Implicit Egotism & Career Choice

- Does the effect go beyond where you decide to live?
 - Dennis: 40th most common name in US
 - Jerry 39th, Walter 41st
 - Across the US
 - 270 dentists named Jerry
 - 257 dentists named Walter
 - How many named Dennis?

482



More Recent Evidence: On Average...

- **Food**

- We prefer chocolates, crackers, and teas that include the letters of our own names

- **Sports**

- Baseball players whose names start with *K* are unusually likely to strike out



- **School**

- Students with *C* and *D* initials have lower GPAs than those with *A* and *B* initials
 - Actually end up attending lower-ranked law schools

- **Politics**

- The 2000 presidential election: donations to Bush and Gore



Reducing Escalation in Yourself

1. Set limits for yourself before beginning; even if you don't strictly conform to them, you'll still be better off
2. Distinguish between sunk & opportunity costs
 - Focus on future payoffs rather than past investments
 - Be willing to cut your losses
3. Consult with others who have no emotional stake in prior commitments
4. Never fall in love with only one option...



Some Final Advice...

Warren Buffet

“When you find yourself in a hole, the best thing you can do is stop digging.”



W.C. Fields

“If at first you don’t succeed, try, try again. Then quit. No use being a damn fool about it.”



Water & Wastewater Leadership Program

- Two intensive weeks of study at the University of North Carolina
- The program provides:
 - World-class faculty
 - Fabulous facilities
 - Way too much food
 - Variety of pedagogies
 - Cases
 - Role-plays
 - Simulations
 - Wonderful networking opportunity



Leadership Program Themes & Objectives

- Self-awareness and self-assessment
 - 360° feedback
- Leading & managing skills
 - Decision making, negotiation
- Thinking strategically
- Financial analysis
- Taking it home & putting it to work
 - Personal development plan
 - Business improvement plan

