Use Leadership Skills That Apply to Behavioral Economics to Avoid the Sunk Cost Fallacy

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Coach Vince Lombardi exhorted his players, telling them, "Winners never quit, and quitters never win." Following this advice in a financial planning practice can lead to costly problems because, sometimes, quitting a project is the best option. Not quitting could result in throwing good money after bad. Practice leaders need to be aware of this possibility and use their leadership skills to avoid this dysfunction or lead their team to the correct change of course.

The sunk cost fallacy, which is the belief that a project should be continued because of past resources expended on it, is the main source of this dysfunction. While it is easy to describe this way of thinking, it's more important to answer two questions. First, what is it about human nature that leads to this mistaken belief? Second, what is the right way for leaders to assist their teams with decisions to quit or continue?

Classical economic theory is based on rational decision-making and it describes how human nature supports irrational behavior. It would be irrational to continue a project in some circumstances, but it's human nature to potentially accept the sunk cost fallacy and irrationally continue the project rather than rationally abandoning it. However, leaders can develop a successful goal-based project using the leadership skills of inclusion, respect, and reward in the project design and review process to avoid the sunk cost fallacy.

4 Elements of Behavioral Economics and the Sunk Cost Fallacy

Four elements of behavioral economics—loss aversion, commitment, status quo bias, and people mentally accounting for costs and benefits in

silos rather than the aggregate—combine into a powerful force against making the right decision by supporting the attraction of the sunk cost fallacy.[1]

With loss aversion, people feel the pain of loss greater than the pleasure of gain. For example, a nice bottle of wine provides a certain amount of pleasure in ownership and imbibing. If a person accidentally drops and breaks their bottle of wine, they'll feel more pain than the wine would have provided pleasure. Regarding investing, a 20 percent market loss hurts more than a 20 percent market gain pleases.[2] To a classical economist, this thinking is illogical. Regarding the sunk cost fallacy, a person would factor in the pain of losing all the previously invested resources, even though it is a past expenditure. Loss aversion clouds the decision-maker's thinking. The logical decision should be based on potential future costs and benefits.

While loss aversion is generally about objective investments like money, commitment refers to the decision-maker's perception of how others would view their quitting. For example, dieters who publicly declare they are going to eat right to lose weight will avoid being caught snacking on cake between meals.[3] This consideration of what others might think affects the decision-making process dysfunctionally. A project manager would try to avoid "loss of face" by continuing a project doomed to failure.

Commitment and loss aversion contribute to the third element called status quo bias, which states people prefer things to continue as they are. Take an employee's decision of which health plan to choose if given a choice of a new plan with lower costs and better benefits, or keeping their current plan. New employees choose the new, better plan at a much greater rate than current employees who would have to change plans. It is human behavior to prefer the status quo over change.[4] This bias supports the sunk cost fallacy. A project that is underway is easier on the mind of a decision-maker than the cost and risk of changing. This is a natural mindset. While the status quo may be perfectly fine, it should be tested to arrive at a rational decision, not just accepted.

Adding to these three aspects of behavioral economics is how people mentally account for costs and benefits. People assign a different value to the profits (free money!) than hard-earned cash they invest.[5] Regarding the sunk cost fallacy, the first effect comes from how the decision-maker accounts for the source of the resources. They may decide one way if it's their own money on the line, but another way if it's employer dollars. Secondly, decisions may differ based on the rewards of the project. If the decision-maker won't be better off if the project succeeds, they'll make a different decision than if they were to reap the rewards of success. Thirdly, mental accounting may depend on the other three behavioral economic factors—loss aversion, commitment, and status quo bias—which affect how elements of a decision are valued.

Making the Quit or Continue Decision

A hypothetical practice's marketing program serves as an appropriate example to review how leaders can approach the quit or continue decision. The practice must get the word out that they are open and ready to provide spectacular service. Let's assume that, for the past year, they have paid for a website to be developed and maintained, had a blog posted on their website, funneled the blog information through Facebook and Twitter, linked with other professionals on LinkedIn, held webinars advertised through social media, and sponsored charitable events. The project is being run by Jordan, the marketing manager hired this year. The practice leader, Taylor, reviews the results but can't associate the modest growth in their practice

directly to marketing. Taylor asks Jordan, "Should we continue this marketing plan?"

According to the sunk cost fallacy, Jordan's answer could be, "Taylor, we have spent so much already, it is a shame to step away now." This is an illogical answer based on the behaviors of loss aversion, commitment, and status quo bias. The mental accounting of costs and benefits also plays a role: Jordan's loss aversion might sway the decision based on the thought that, "If only I had one more year on this project, I am sure I could prove that it was worthwhile and not a big waste." Also, Jordan may want to avert the loss of a good job.

Commitment plays a part since Taylor hired Jordan due to the expertise and enthusiasm he displayed in the interview. Throughout the year, Jordan cheered on the efforts, spotlighting events, blog posts, etc., to show how important the marketing effort was to the practice. By being so committed, it would be difficult and embarrassing for Jordan to quit the project.

Status quo bias affects the decision as the project is running smoothly and efficiently and has output. Jordan believes that "Changing horses mid-race is not a good idea." It's easier to leave things as is because the costs are known, the processes are in place, and the marketers produce.

Jordan mentally accounts for the money spent and the possible rewards. "It's not my money," he thinks. "It has been budgeted and spent transparently." Jordan will still get paid if the project continues. There's no big upside to stopping this project, but there is a significant downside.

Leadership for Developing Goal-Based Projects

The main problem for Taylor, in the aforementioned example, is the lack of measurements of success. This is the first leadership lesson to combat

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the sunk cost fallacy: projects need strategic goals describing specific end results. Objective milestones must be measured for progress. The project's goals must be attainable and relevant to the practice, so rational decisions can be made. Cut-off dates for decisions should be in place. The sunk cost fallacy won't have strength if goals are set since nothing in the strategic goals applies to the past. It will be dysfunctional to say, "But we have invested so much already." It will be possible to say, "Yes, we have spent more than expected, but we did reach our milestones. We feel confident that we are getting appropriate ROI, and this will improve because we have already invested to overcome barriers to market entry." Goal-setting is an important team activity that leaders must implement.

Developing a successful goal-based project uses three key leadership skills: inclusion, respect, and reward.[6] A leader who uses these skills during the project design process will have greater success. In this case, inclusion means including team members in discussions and decisions that affect their jobs.[7] In the marketing project example, if the practice leader spent time in the initial design phase—discussing what needs to be done, by when, and how—then the project manager will have a much clearer understanding of the project. Contrast this inclusive leadership style with that of authoritarian leaders who state what is to be done, by when, how, and by whom.

This inclusive dialogue needs to be respectful. In the case study, the project manager was hired because of their expertise. Leaders sometimes mistakenly believe they know as much or more than their team members. That is disrespectful. Micromanaging is also disrespectful as it shows a lack of trust in the team member. Leaders who view each team member as valuable will develop a trusting relationship that results in much better communication and work effort.[8]

Another important leadership skill is the ability to craft appropriate rewards for work done. Rewards are the motivators for a team member. If the reward structure is not rewarding, then motivation is not present. To make the rewards work, the team leader should have individual discussions with the team members they want to motivate. Perhaps reward structures cannot be fully individualized, but rewards should be tailored to the team member as much as practical to motivate individuals.

Rewards can be objective (salary) or subjective (praise). The difference is sometimes described as extrinsic versus intrinsic rewards. Extrinsic rewards help the team member eat, have a home, and buy a car. Intrinsic rewards motivate the team member to feel good about their work, leader, and organization.[9] An example of individualization that includes both extrinsic and intrinsic elements is if the team member is allowed to direct a portion of their organization's charitable donations to a cause. This is both extrinsic and intrinsic—extrinsic because it has a dollar value substituting for personal donations, and intrinsic because it appeals to the employee's charitable nature. This could be individualized further by giving a choice between directing cash or being allowed paid time off to volunteer. In summary, rewards need to be rewarding to individuals; good leadership is individual leadership.

These leadership skills are especially helpful in deciding whether the project should continue. Because of prior planning, there is a basis for effectively reviewing the goals and achievements, which can be compared to the costs and results. Now is the time to reflect on how the goals were set originally to determine if they are still correct for the project. Possibly, it is time to walk away. To counter behavioral economics, the team leader should be aware of how loss aversion, commitment,

and status quo bias are affecting the decision-making. The trust that has been built through good leadership allows for these frank discussions of feelings and beliefs about the project.

This review process is also the way to modify the mental accounting each team member has regarding the project. The review will surface problems and opportunities to leverage strengths. The problems could include team members not feeling accountable for the project and, thus, not being invested in how resources are allocated. Another problem is team members may feel disassociated from the project's potential success because there are no rewards. Motivation may still exist because team members are being paid a salary, but there is a lower incentive to complete the project as stated in the goals.

Strengths that surfaced during the review can be leveraged. Perhaps motivation is high, which might translate to team members accepting greater responsibility or providing more effort in crunch times. Reward structures might be found to be correct—and reminders of these reinforce motivation. Goals can be revised to take advantage of these and other strengths. Potential changes can build on strengths, such as discovering some team members would welcome training to improve their performance and worth to the organization. The key is to have the review discussion based on the prior goal-setting. Using leadership skills that apply to behavioral economics is the key. The sunk cost fallacy is now history in the organization. ■

Endnotes

1. See the *Handbook of Behavioral Economics—Foundations and Applications* by B. Douglas Bernheim, Stafano DellaVigna, and David Laibson.
2. Ibid.
3. Ibid.
4. Ibid.
5. Ibid.
6. See *How Successful Teams Work: What Science Says about Leadership High-Performance Teamwork* by the author of this article.
7. Ibid.
8. Ibid.
9. Ibid.

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