Adam Stober
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Paper 2

Item up for auction	**$20.00**
Amount of my first bid	**$19.01**
Amount I paid	**$28.01**
Amount I "won"	**$ 0.00**

Hsee: Managerial Decision Making
Chicago Booth: October 13, 2009

Executive Summary

This paper introduces the concept of an *escalation of commitment* by recounting a personal experience, and discusses its central role in the success of "Entertainment Shopping" websites like Swoopo and Bidfire

Introduction

I recently participated in an experiment, which I later learned was intended to showcase an *escalation of commitment*. As a willing participant in an MBA-level Managerial Decision Making class demonstration, I thought I had outsmarted my classmates by bidding $19.01 for a single $20 bill. Given that the minimum bid amount was $1, I assumed that nobody would be willing to bid over $20 for a $20 bill. However, I failed to recognize that the structure of the auction had created a powerful and perverse incentive for the second highest bidder. The "winner" of the auction was required to pay the amount they bid in exchange for the $20 bill, while the second highest bidder had agreed to pay their bid to the auction house—in this case, Professor Hsee—and receive nothing.

If I allowed myself to fall victim to hindsight bias, I would believe that I should have realized that the design of the game created a "winner's curse" for the group's aggregate participation as soon as any single bid exceeded $10. However, Professor Hsee indicated that virtually no group of first-time participants in this experiment act in anything other than some sub-optimal behavior. When one of my classmates entered a bid for $20.01, I recognized that I had entered a losing scenario. I became aware that I was in a position where I owed $19.01 but would receive nothing. With the spotlight of 60 classmates cheering me on, I decided to outbid my classmate rather than cut my losses. After several cycles of back-and-forth bidding, I decided to withdraw from further participation. After all, my opponent was clearly not rational, since he had bid over $20 for a $20 bill!

I later learned that my behavior was far from rational as well. Removing myself from the auction was one way to rationally overlook my sunk costs, counteract my emotion to seek "revenge," and avoid escalating my liability any further.

“Entertainment shopping” disarms *escalation of commitment* countermeasures

A recent evolution in internet auctions has been described, by its own proponents, as “entertainment shopping.” A leading player in this category is Swoopo, which was founded in 2005, received early-stage funding from Wellington Partners in late 2006 and a follow-on from August Capital in 2009 (August Capital, 2009). Swoopo operates in 6 countries and faces competition from similar sites such as Bidfire.

In short, the “entertainment shopping” premise is as follows: users place incremental bids on items up for auction at significant discounts to their retail costs. In August, “a new 40-inch Samsung TV, which normally sells for $1,500, sold for $67.92, and a white LG refrigerator with a price tag of $1,498 went for a cool $77.90” (Stone, 2009). The catch is that each bid costs a user a pre-determined, relatively trivial amount. “Competing bidders spent a cumulative $2,337 in their losing effort to buy the $1,498 refrigerator” (Stone, 2009).

Swoopo charges 60 cents per bid, and sells the right to bid ahead of time, in “BidPacks,” ranging from 40 to 1,000 bids (Swoopo, 2009). This structure gives users the false belief that each of their bids is a sunk cost, giving an incentive for individuals to discount the incremental amounts they are spending on each bid.

Under these circumstances, participants are likely to underweight the impact of the situation—the odds of “winning” are infinitesimal. Instead, participants inaccurately over-attribute their participation as a method to increase their wealth by buying an item at a price below retail via the auction method described above. **In entertainment shopping, traditional methods of controlling an escalation of commitment are not available.** Users are unable to communicate, so there is no way to collude to ensure an optimal outcome for the users (as opposed to the auction house). The “powerful first strike” (Hsee, 2009) is not an option, since bids are required to be placed in pre-determined increments. Individual users are able to set their own reservation prices, that is, the maximum amount they are willing to spend; however, they may be likely to do so based on the amount of the item for sale, which is insignificant relative to their potential acquisition cost. More importantly, without being able to collude with all other auction participants, a reservation price has no impact.

Upon further inspection, “entertainment shopping” appears to be gambling, thinly disguised as shopping. However, the disguise has been effective enough to allow entertainment shopping to avoid the additional costs of regulatory burdens that governments traditionally impose on gambling institutions, at least for the time being. By disabling methods of counteracting the natural effects resulting from a user’s escalation of commitment, Swoopo, Bidfire, and other sites are able to profit heavily off from their customers, since the odds are tilted so heavily in favor of the house.

While this paper does not condone or condemn the business strategy or ethical implications of these sites’ operations, it is worth noting that participants enter the auctions willingly. While an individual user’s expected value of participation is most likely negative, users may derive enough utility from the enjoyment or “entertainment” of participating to more than offset their expected financial losses.

Conclusion

"Economic Man makes logical, rational, self-interested decisions that weigh costs against benefits and maximize value and profit to himself…but Economic Man has one fatal flaw: he does not exist" (Lambert, 2006)

Professor Hsee said he would keep participants' payments, and he did, presumably to ensure that participants were sensitive to the authenticity of the auction. While it would be nice to have my $28.01 back, I find $28.01 relatively insignificant as the cost of an important lesson, especially when considered in the context of the tuition and opportunity cost I am incurring as a full-time MBA student.

Escalation of commitment is just one example of irrational decision-making that leads humans to make counterproductive decisions on a regular basis. "Unless the decision is very important, a simple and effective strategy is to use expected value as the basis for decision making" (Bazerman, 2009). However, humans often do not follow this basic rule, as exemplified by the very existence of certain insurance companies. When Swoopo suggests that potential users "Bid To Save," many listen, which I would argue is irrational. With respect to the "Bid to Save" claim, participation in "entertainment shopping" is likely to have the exact opposite effect on personal wealth.

Works Cited

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