Throwing good money after Bad

Why would a gambler keep playing, even after losing a lot of money? Economists call it the sunk cost fallacy, a phenomenon which drives us to make bad decisions.

- **By Madeline Grant**

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You've popped down the shops to pick up some milk. Halfway there you remember that this particular shop is actually closed on Sunday afternoons. And as far as you know, there are no others open nearby. Still, you've already spent 10 minutes walking in that direction, so you might as well at least finish your journey, right?

Unless you were already desperate to stretch your legs, this is a transparently stupid way of thinking. Yet, bizarrely, this illogical cognitive pattern is widespread in decision-making; often, involving choices with far higher stakes.

This is the logic that says 'I've sunk a lot of money into my old car. I can't just scrap it now. I really should replace that faulty gearbox'

A gambler might call it chasing your losses. The British saying – 'don't throw good money after bad' – captures a similar sentiment. Economists call it the sunk cost fallacy, and it's ubiquitous.

We all do it. Ever gone to the cinema and stayed to the end of a film you actually loathed 10 minutes in – or watched yet another season of what was once your favourite TV show? This is the logic that says "I've sunk a lot of money into my old car. I can't just scrap it now. I really should replace that faulty gearbox". (See also: those who stay in bad relationships for several additional years because they don't want their time together to have been 'all for nothing').

What links these examples is the phenomenon of continuing to throw good resources (time or money) after bad, hoping for things to improve when there's no good reason to believe they will.

In other words, people are loath to cut their losses. We are much more likely to continue to senselessly plough time or money into a project that isn't working out, in the hope that it will get better, than take a hit and walk away. What drives this is optimism (that, against the odds, the situation will improve) and an aversion to failure.

Even animals can show a sunk-cost bias. One recent**University of Minnesota** study found mice and rats were just as likely as humans to fall foul of lab experiments involving delays and rewards. In each case, the more time invested waiting for their 'prizes' (for the rodents, flavoured pellets, for the humans, funny videos) the less likely they were to quit the pursuit before the delay ended. According to some researchers, this pattern may suggest some evolutionary reason for this economically irrational flaw.

'A winning hand'

At work, the consequences of desperately hanging on to irrecoverable costs can be catastrophic. For smaller firms, this could mean, for instance, putting off firing a worker you have spent months training, even though it was clear from the outset they were never going to cut it.

But this same spirit pushes people towards totally illogical huge investments. Thinking only in terms of future possible gains means they fail to factor in unrecoverable funds already spent. It’s easy to see why.

After you’ve invested £10 million ($13m) in a project, which hasn’t delivered, the case for throwing in a further £5 million is far easier to justify if you only consider returns on £5 million – rather than £15 million. But in reality, of course, you also don’t want to look stupid by abandoning it.

In his book Thinking, Fast and Slow, Nobel laureate Daniel Kahneman hypotheses that ‘sunk cost’ thinking often explains why firms turn to new management, or hire consultants, at this stage of a project’s decline. Not, he believes, because they are necessarily more competent than the original managers – but because the new arrivals carry none of the political baggage (and the associated reluctance to cut losses and move on).

Like a gambler ‘chasing losses’ at a poker table, people stuck in the sunk cost trap will pretend that they have a winning hand. Nick Leeson, the infamous ‘Rogue Trader’ who caused the collapse of Barings Bank in 1995, followed similar reasoning in trying to recover his position from a series of disastrous early trades.

"Rogue trader" Nick Leeson brought down Barings Bank in 1995 with losses of £827 million (Credit: Getty Images)

Political overspend

Making continuous foolish decisions driven by sunk-cost analyses will eventually lead firms to haemorrhage money or market share and consequently grind to a halt.

By contrast, there are fewer checks and balances around political decision-making. It certainly doesn’t help that around the world, political U-turns are viewed as inherently weak – further incentivising politicians to persist with costly decisions.

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Many examples bear out this trend on a global level. Public infrastructure projects are notorious for running over budget –

Britain's proposed 'High Speed Rail 2' project – **on course to overspend by £50 billion ($65bn)** and counting, for instance.

Former First Lady Nancy Reagan lead the 'Just Say No' campaign part of the Reagan adminstration's War on Drugs (Credit: Getty Images)

Japan, too, has a **costly addiction to infrastructure spending**. This is part of the reason the country has been saddled with the highest level of national debt in the world. Many of these projects have offered very little fiscal stimulus, and there are numerous 'bridges to nowhere', both literal and metaphorical.

In the US, the "war on drugs" policy increased the number of people behind bars, creating the most extensive prison infrastructure in the world. Yet despite the **wealth of evidence**that focusing on supply has done little to curtail drug abuse (and caused a host of terrible side effects) lawmakers would now struggle to dismantle this pervasive system.

The sunk cost trap drives bad decisions in the billions and trillions, but it also impacts personal finances – individuals waste money needlessly pouring their savings, for instance, into repairing a property that gains no value.

Fighting the fallacy

The sunk cost fallacy, then, has huge significance on a micro and macroeconomic level – for personal and political decision-making around the world.

Yet a greater awareness of this illogical thought process may help us avoid falling into these traps – and to hold business leaders and politicians to account when they do.

So, how can we avoid the pitfalls?

“We are all susceptible to these biases”, says Dr Jim Everett, a social psychologist and researcher at Leiden University. “But often, we can partially offset them by taking a step back and thinking through the alternatives.”

When weighing up whether to persist with a course of action, he says, always ask yourself: ‘What would I gain or lose if I stuck with this option, and what would I gain or lose if I switched?'

If in doubt, Everett recommends reflecting on the entire chain of decisions that has led to where you are now, and considering the counterfactuals – in other words, what’s true and not true, a reality check.

“If presented with the same choice again, would I make the same decision? If not – why not?”

So, it’s a simple idea, with global ramifications. And ultimately, it all goes back to the first lesson of gambling. Any good poker player knows when to fold.

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