World Academy of Science, Engineering and Technology
International Journal of Economics and Management Engineering
Vol:10, No:12, 2016

Escalation of Commitment and Turnover in Top Management Teams

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Abstract : Escalation of commitment is defined as continuation of a project after receiving negative information about it. While literature in management and psychology identified various factors contributing to escalation behavior, this phenomenon has received little analysis in economics, potentially due to the apparent irrationality of escalation. In this study, we present an economic model of escalation with asymmetric information in a principal-agent setup where the agents are responsible for a project selection decision and discover the outcome of the project before the principal. Our theoretical model complements the existing literature on several accounts. First, we link the incentive to escalate commitment to a project with the turnover decision by the manager. When a manager learns the outcome of the project and stops it that reveals that a mistake was made. There is an incentive to continue failing projects and avoid admitting the mistake. This incentive is enhanced when the agent may voluntarily resign from the firm before the outcome of the failing project is revealed, and thus not bear the full extent of reputation damage due to project failure. As long as some successful managers leave the firm for extraneous reasons, outside firms find it difficult to link failing projects with certainty to managers that left a firm. Second, we demonstrate that non-CEO managers have reputation concerns separate from those of the CEO, and thus may escalate commitment to projects they oversee, when such escalation can attenuate damage to reputation from impending project failure. Such incentive for escalation will be present for non-CEO managers if the CEO delegates responsibility for a project to a non-CEO executive. If reputation matters for promotion to the CEO, the incentive for a rising executive to escalate in order to protect reputation is distinct from that of a CEO. Third, our theoretical model is supported by empirical analysis of changes in the firm's operations measured by the presence of discontinued operations at the time of turnover among the top four members of the top management team. Discontinued operations are indicative of termination of failing projects at a firm. The empirical results demonstrate that in a large dataset of over three thousand publicly traded U.S. firms for a period from 1993 to 2014 turnover by top executives significantly increases the likelihood that the firm discontinues operations. Furthermore, the type of turnover matters as this effect is strongest when at least one non-CEO member of the top management team leaves the firm and when the CEO departure is due to a voluntary resignation and not to a retirement or illness. Empirical results are consistent with the predictions of the theoretical model and suggest that escalation of commitment is primarily observed in decisions by non-CEO members of the top management team.

Keywords : discontinued operations, escalation of commitment, executive turnover, top management teams
Conference Title : ICEFM 2016 : International Conference on Economics, Finance and Marketing
Conference Location : Sydney, Australia
Conference Dates : December 15-16, 2016