Competitive Irrationality: When Being Better Is a Bad Strategy

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Abstract

Some situations allow managers to forfeit absolute profit in exchange for a favorable standing as compared to competitors. In this article, the author explains when such decisions may be wrong, which deeply-rooted evolutionary reasons are responsible for their allure to managers, and how managers can improve their decision making.

Plutarch, the Greek historian, writes in his biography of Julius Caesar: "In his journey it is reported, that passing over the mountains of the Alps, they came through a little poor village that had not many households, and yet poor cottages. [Caesar spoke:] I had rather be the chiefest man here, than the second person in Rome."

Caesar's sentence might strike us as a heroic declaration of the will to lead and a claim to first place. And in fact, business leaders around the world frequently make decisions in exactly this spirit: They make sure they compare favorably to their competitors, even when they simultaneously forfeit absolute gains.[1, 2, 3]

Consider the situation in the European bottling industry in 2003, when the bottling machinery producer Sidel started to engage in extremely aggressive pricing, setting off the losses it incurred in making this move with cross-subsidies it received from its parent company Tetra Laval. Sidel's pricing policy naturally depressed profit margins at its most important competitor, German Krones AG. Industry observers interpreted Sidel's move as an attempt to drive Krones out of the market and win market share – despite the fact that nobody in the industry actually believed this plan could ever succeed. After all, Krones had a very strong standing in the industry, a solid equity ratio of 45%, and rising profits. Even Krones' CEO Volker

Kronseder was unable to grasp the logic of Sidel's behavior, and he repeatedly called it "irrational." Apparently, Sidel was willing to incur some losses only to hurt Krones' financial result even more.

Similarly, when the MP3 file format made digital music distribution technologically viable and illegal file-sharing over the internet started to flourish, all major record labels in Germany were struggling to deal with the new technology and its commercialization. After several failed initial attempts, the record labels realized that only a common platform would be practical, as customers expected music from all labels to be available in one place. Consequently, all major labels agreed to build a joint platform, to be called "PhonoLine." The following negotiations about the implementation, however, were slow and plagued by what then-Universal-CEO Tim Renner describes as "vanities:" The different labels did not want to join Universal's already existing Popfile platform (which would likely have been the fastest way to go to market with a working product) for fear of falling behind technologically, and they argued about the choice of the IT contractor, worrying they could lose influence. All the ensuing delays allowed Apple to prepare its entry into the German market, which had long been expected since its "iTunes" service was already tremendously successful in the US market. When the individual music labels finally overcame their partial interests and PhonoLine went live, Apple was ready to launch iTunes in Europe, too, where it would take the market by storm. The PhonoLine platform was abandoned soon after. As all major labels were unwilling to take the risk that one of them would be at a small advantage over the others in the joint platform, they delayed the negotiations until it was too late. Apple took over the market virtually uncontested, and the major labels were left with nothing – but, of course, they had made sure none of them fell behind compared to the others.

A third example for such behavior was the break-up of a large airline price-fixing cartel in the UK. Virgin Atlantic Airways and British Airways had illegally agreed on prices for fuel surcharges on long-haul passenger flights between 2004 and 2006, until Virgin Atlantic Airways decided to blow the whistle on British Airways and informed the authorities about the cartel. Because of this move, it was granted immunity from prosecution. British Airways, in contrast, was fined £121.5 million by the UK's Office of Fair Trading and another $100 million by the US Department of Justice. Additionally, the threat of class-action lawsuits forced British Airways to set aside £350 million for potential compensation claims. Virgin Atlantic Airways had to do so as well, but only to a much lesser amount of £32.5 million. So while Virgin Atlantic Airways caused British Airways great harm, it also came at a cost for Virgin Atlantic Airways itself – even beyond the cost of not being able to profit from fixed prices anymore.

The obvious common theme of the three given examples is that companies were willing to give up absolute profits to make sure their relative position as compared to their competitor would improve.

How being better than your competitor may be irrational

For every example given above, one might think of rational reasons that would justify the observed actions. Sidel might have hoped to gain market share in order to raise prices later and increase profits in the future. The music majors might have felt the need to be tough negotiators to not obtain a reputation of being soft for future interaction with each other. Virgin Atlantic might only have preempted British Airways in breaking up the cartel, avoiding being the party to bear the larger fines.

However, research in social psychology and my own research repeatedly demonstrated that managers make decisions which hurt their competitors *even when they cannot expect any benefit from it.*[4, 5, 6] The sheer fact that they might be able to improve their relative standing is enough motivation for managers to perform actions that sacrifice absolute gains. And when rational reasons do in fact exist, managers may still pay *excessive* attention to relative standing versus their competitors. Management researchers have termed such behavior "competitive irrationality."[2, 7]

How managers' behavior is driven by emotions

The mentioned empirical findings, of course, provoke the question of why managers behave in such a way. Psychologists' answer to this question rests on what is called social comparison theory.[8] The term *social comparison* refers to comparisons that people make with regard to other people ("Will I make more sales than Jones this year?"), as opposed to, for example, an absolute standard ("Will I make the sales quota this year?") or themselves at a different point in time ("Will I beat my personal best from last year?").

There are different reasons for actively making such comparisons.[9] First, comparisons can be used to get an adequate picture of one's performance or abilities. By comparing to others, one can better understand whether one's own performance or abilities are strong or weak. In order to gain such knowledge, people tend to compare to others that are similar to them, like colleagues. Second, one may attempt to boost one's self-esteem by comparing to people that are worse off. Comparing to a recently laid-off co-worker would be an example for such a comparison. Third, one may try to obtain new capabilities or learn new coping skills by comparing with people that are doing better than oneself. For instance, a manager might compare herself to her boss in order to learn skills required to move up the career ladder. Beyond such active comparisons, social comparisons are also often involuntary and may even be completely unconscious.[10, 11] For example, it is hardly conceivable not to automatically compare oneself when seeing performance evaluations of co-workers or when seeing somebody else's paycheck.

Obviously, social comparisons can cause various emotional reactions.[12] When a manager, for instance, compares herself to another one who is less well-off, she may feel an increase in subjective well-being. It just feels good to be number one! When a comparison, however, turns out to be disadvantageous, a manager may feel relatively deprived and less happy. In fact, this relativity of judgment is typical not only for managers, but for most people.

In recent years, the phenomenon has spurred a vast amount of research in the field that is called *happiness research*. For example, the relativity, or *positionality*, of judgment has been used to explain what has become known as the "Easterlin paradox:" Within a country, at a given time, those who are better off financially are also happier than those who are worse off. However, at the same time, making everyone better off does not necessarily make everyone happier. This apparent paradox is resolved once one takes into account that relative position is an important factor in determining subjective well-being. After all, it is obvious that increasing income for everybody will not change happiness if happiness depends on relative income and not on absolute income.[13] Of course, this notion is by no means radically new in economic thought. Already John Stewart Mill recognized that "Men do not desire merely to be *rich*, but to be *richer* than other men".[14] Yet, this kind of thinking has only recently risen to prominence again in economic research.[15]

Despite the popularity of *happiness* research, however, people's propensity towards positional thinking actually seems to spring from a darker side of the human psyche. Psychological studies show that people do not so much desire to be happy, but they rather seem to strive to avoid unhappiness. It is less the positive emotions of pride and joy that motivate people to come out ahead of others, but rather the dreaded negative emotions of spite and envy.[16]

Whenever social comparisons give rise to emotions such as spite or envy, they are accompanied by the urge to rid ourselves of them. When we feel envious, we want to remove our comparison counterpart's superiority. In the case of spite, we desire to damage our comparison counterpart's parity.[17] It is plain to see that these emotions carry a strong incentive to make positional decisions, regardless of how these decisions might affect our absolute position.

Positional thinking: a product of evolution

Knowing all this raises the question of why humans possess emotional mechanisms that make them decide in a positional manner in the first place. Evolutionary psychologists argue that the desire for a favorable relative position evolved during the course of evolution and is at least partially determined in our genes. Paying attention to relative position historically increased an individual's chances of reproductive success by ensuring preferential access to scarce resources like food and mating partners. Such scarce resources were allocated not according to some absolute standards, but instead according to relative standing within a local group: If food is in limited supply, the highest-ranking individual may get to eat first.[18, 19] Hence, such competitiveness, or people's "proclivity for besting others," as education researcher Alfie Kohn once put it, is a basic human tendency. And in many cases, it is a tremendous motivator and propels people to great achievements. In others, however, it may lead to grossly maladaptive behavior as the examples in the beginning of this article illustrate.

Manager, know thyself – and relax

So, what should managers do to make sure they do not fall into the trap of trying to be better than others at all cost? I call for two simple measures: Be aware of your overly competitive tendencies, and do not make competitively relevant decisions under time pressure.

First, being aware of the psychological mechanisms that govern our behavior is an important value in itself. It allows us to understand and make sense of our behavior, but it also – and more importantly – enables us to take back control.[20] Knowing that giving in to the urge to beat the competitor may not be the best strategy allows us to step back, reconsider, and potentially make a smarter decision – even if it may mean to live with the fact that a competitor is thriving as well.

Second, competitively relevant decisions should never be made under time pressure. Time pressure tends to make us more sensitive to relative standing, even at the expense of absolute gains. Therefore, the clock speed should be reduced for such decisions. Of course, this is easier said than done for most of us, as we tend to be constantly pressed for time. Yet, besides "hard" means to reduce time pressure, like renegotiating deadlines, there are other, "softer" ways of alleviating time pressure: Time pressure is largely perceptual, so changing the environment of the decision maker may be sufficient to reduce it. Measures such as moving to an offsite location with the executive team, or simply taking a walk around the block, may help reduce perceive time pressure and improve our decisions.[2, 7, 21]

These two simple measures are good safeguards against making decisions that are excessively biased towards relative position. They should be employed by any manager who makes decisions that might be prone to overly positional logic. After all, you do not want to find yourself in the situation of King Phyrrus after the battle of Asculum, about whom Plutarch reports: “Pyrrhus answered one, who rejoiced with him for the victory they had won: If we win another of the price, quoth he, we are utterly undone.”

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Endnotes

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