



PART 3

Read the text below and answer questions 27–40.

THE ENDOWMENT EFFECT AND THE SUNK COST FALLACY

Standard economic logic pictures the decision-maker as forward-looking: choices should depend on expected future costs and benefits, not on what has already happened or on who currently owns what. Behavioural research repeatedly shows a more complicated reality. Two of the most reliable departures from the rational-actor model are the endowment effect and the sunk cost fallacy. Both reveal how reference dependence and emotion can quietly reshape judgement: ownership can inflate what something seems “worth,” and prior investment can make people persist even when quitting is objectively wiser. Because these patterns occur in ordinary consumer life and in high-stakes organisational settings, their consequences are not merely theoretical—they can translate into large personal losses and costly institutional errors.

The endowment effect refers to the tendency to assign a higher valuation to an item simply because it is “mine.” The object may be identical in every physical respect, yet the mind treats possession as a psychologically meaningful boundary. A classic demonstration uses a simple mug: some participants receive a mug and are later asked the minimum amount they would accept to sell it (willingness to accept), while others who do not own a mug are asked what they would pay to buy one (willingness to pay). Across many replications, owners demand substantially more than non-owners offer. The gap is difficult to reconcile with the idea that preferences are stable and independent of ownership, because the mug itself has not changed—only the person’s relationship to it has. The result highlights how valuation can be constructed from context rather than discovered like a fixed price tag.

These findings also sit uncomfortably alongside the Coase theorem, which assumes that if transaction costs are low, goods will be traded to those who value them most, and initial ownership should not systematically alter final allocation. If an owner truly values the mug less than a potential buyer does, the object should move through exchange. Yet the experimental evidence suggests that ownership itself shifts perceived value, raising the price the owner demands and lowering the likelihood of trade even when bargaining is frictionless. One explanation is divestiture aversion: giving up what one has is experienced as a loss rather than a neutral swap. Loss aversion makes that loss feel disproportionately painful, so the owner requires extra compensation before parting with the item.

Crucially, the mechanism does not require long histories of possession. People can develop psychological ownership quickly—sometimes within minutes—because



possession triggers a sense of “this is part of my domain.” Once that feeling appears, even temporary holding can alter valuation, and the item’s value becomes partly emotional rather than purely instrumental. Marketers can harness this by offering free trials and “try before you buy” experiences that make returning the product feel like relinquishing something already incorporated into daily life. The consumer may interpret the discomfort of returning as evidence of genuine preference, when it is sometimes only the emotional cost of giving up an endowed object.

The sunk cost fallacy involves a different error: continuing an activity because of resources already spent, even when the future payoff no longer justifies further investment. In principle, irrecoverable past costs should be irrelevant; a rational agent should ask only what happens next. In practice, many people feel compelled to “justify” earlier spending, so they keep paying, keep working, or keep waiting—throwing good money after bad. The pull is strengthened by retrospective utility: people judge a decision by whether it can be narrated as sensible in hindsight, not merely by whether it maximises future welfare. Quitting can feel like admitting an earlier mistake, and that admission carries emotional weight.

Several forces combine to trap individuals and organisations. Loss aversion makes stopping feel like “locking in” the loss, whereas continuing preserves the hope—often illusory—that the investment can be redeemed. Cognitive dissonance adds pressure: if a person believes they are competent, abandoning a costly effort creates psychological discomfort, so they reinterpret persistence as virtue. A commitment-and-consistency motive intensifies the effect because people want their actions to appear coherent over time; changing course can feel like a threat to identity. In workplaces, the same logic becomes social. Teams may fear reputational damage, and managers may worry that terminating a project signals failure to colleagues, investors, or supervisors, even if objective indicators point toward stopping.

A particularly destructive variant is escalation of commitment, in which decision-makers double down precisely because the earlier choice was public, costly, or tied to professional status. When an initial decision is visible, backing away risks embarrassment; when it is expensive, admitting error feels proportionally painful; when it is linked to status, reversing course can seem like a threat to credibility. These conditions help explain why large projects sometimes continue long after warning signs appear. Similar dynamics can operate in markets. Auctions, for example, can amplify feelings of endowment once bidders begin to treat “their” bid as a form of possession, and competition can add emotional heat. However, the presence of these pressures does not mean auctions always



produce irrational outcomes; rather, they create a setting in which the endowment effect may become more likely and more intense for some bidders.

Although these biases are robust, mitigation is possible. One practical step is awareness: people often label biased persistence as “loyalty” or “grit,” and they mistake endowed valuation for objective worth. Simply naming the bias can create a brief pause—long enough to ask whether the current choice is being driven by the future or by the past. For the endowment effect, strategies such as focusing on use rather than possession can weaken the emotional premium attached to ownership. For sunk costs, explicit decision rules can help: for example, setting pre-defined thresholds for stopping, evaluating projects by forward-looking metrics, or separating those who made the initial decision from those who review whether it should continue. When institutions treat these biases as predictable features of human psychology, they can redesign processes to support more rational, future-oriented choices instead of relying on willpower alone.

Questions 27–31

Choose **YES** if the statement agrees with the claims of the writer, choose **NO** if the statement contradicts the claims of the writer, or choose **NOT GIVEN** if it is impossible to say what the writer thinks about this.

27 The passage presents the endowment effect and the sunk cost fallacy as having important real-world consequences.

28 The Coase theorem is described as assuming that initial ownership should not systematically alter final allocation when transaction costs are low.

29 The passage states that online auctions are more likely than in-person auctions to produce irrational bidding.

30 The writer suggests that simply naming a bias can sometimes help people pause and think more deliberately.

31 The passage claims that willpower alone is sufficient to eliminate the endowment effect and sunk cost errors.

Questions 32–35

Complete the notes below. Choose **ONE WORD ONLY** from the text for each answer.

Factors influencing biased decisions

- Mug owners name the lowest **32** they are willing to take for giving up the item.



- Even brief possession can quickly create psychological **33**
- Wanting one's actions to remain coherent over time can reinforce a commitment-and-**34** motive.
- Pre-set stopping thresholds are one example of decision **35** used to reduce sunk-cost errors.

Questions 36–40

Select the correct answer.

36 What is the main purpose of the first paragraph?

- A** To argue that these biases apply only to large companies
- B** To describe how auctions are organised in practice
- C** To introduce two influential decision biases and explain their importance
- D** To prove that classical economics is entirely false

37 The mug experiment mainly demonstrates

- A** a gap between selling and buying prices linked to ownership
- B** that people prefer mugs to other consumer goods
- C** that transaction costs are always high in real markets
- D** how marketing strategies determine product quality

38 According to the passage, a rational decision about a sunk cost should focus on

- A** whether the earlier choice can be defended
- B** what happens next
- C** how long the activity has already continued
- D** how publicly the original decision was announced

39 The passage suggests escalation of commitment is especially likely when the original decision was

- A** made in private and at little cost
- B** based entirely on new evidence
- C** public, costly, or tied to professional status
- D** forced by a government regulation

40 The overall conclusion is that these biases

- A** can be reduced through awareness, practical strategies, and organisational design
- B** are rare exceptions that matter only in experiments



- C** disappear once people are given more information
- D** can only be solved through higher incomes

Answer Key

- 27. YES
- 28. YES
- 29. NOT GIVEN
- 30. YES
- 31. NO
- 32. amount
- 33. ownership
- 34. consistency
- 35. rules
- 36. C
- 37. A
- 38. B
- 39. C
- 40. A