

LAST

Word Don't Cry over Sunk Costs

Sunk Costs Are Irrelevant in Decision Making.

There is an old saying: Don't cry over spilt milk. The message is that once you have spilled a glass of milk, there is nothing you can do to recover it, so you should forget about it and "move on from there." This saying has great relevance to what economists call sunk costs. Once these costs are incurred, they cannot be recovered.

Let's gain an understanding of this idea by applying it first to consumers and then to businesses. Suppose you buy an expensive ticket to an upcoming football game, but the morning of the game you wake up with a bad case of the flu. Feeling miserable, you step outside to find that the windchill is about -10 degrees. You absolutely do not want to go to the game, but you remind yourself that you paid a steep price for the ticket. You call several people to try to sell the ticket, but you soon discover that no one is interested in it, even at a discounted price. You conclude that everyone who wants a ticket has one.

Should you go to the game? Economic analysis says that you should not take actions for which marginal cost exceeds marginal

benefit. In this case, if the marginal cost of going to the game is greater than the marginal benefit, the best decision is to go back to bed. In correctly applying this rule, however, it is crucial that you recognize that the price you paid for the ticket is *not* a marginal cost. Even if the ticket was hideously expensive, it was purchased previously. Thus, its cost is not a marginal, extra cost that depends on whether or not you go to the game. The cost has already been incurred and must therefore be dealt with even if you decide not to attend!

With the cost of the ticket out of the picture, your cost-benefit analysis is going to be settled by your opinion that "you absolutely do not want to go." With such a strongly negative opinion, the marginal cost obviously exceeds the marginal benefit, and you should not go.

Here is a second consumer example: Suppose a family is on vacation and stops at a roadside stand to buy some apples. The kids get back into the car and bite into their apples, immediately pronouncing them "totally mushy" and unworthy of another bite. Both parents agree that the apples are "terrible," but the father continues to eat his because, as he says, "We paid a premium price for them." One of the older children replies, "Dad, that is irrelevant."

Although not stated very diplomatically, the child is exactly right. In making a new decision, you should ignore all costs that are not affected by the decision. The prior bad decision (in retrospect) to buy the apples should not dictate a second decision for which marginal benefit is less than marginal cost.

Now let's apply the idea of sunk costs to firms. Some of a firm's costs are not only fixed (recurring, but unrelated to the level of output) but sunk (unrecoverable). For example, a non-refundable annual lease payment for the use of a store cannot be recouped once it has been paid. A firm's decision about whether to move from the store to a more profitable location does not depend on the amount of time remaining on the lease. If moving means greater profit, it makes sense to move whether there are 300 days, 30 days, or 3 days left on the lease.

Or, as another example, suppose a firm spends \$1 million on R&D to bring out a new product, only to discover that

the product sells very poorly. Should the firm continue to produce the product at a loss even when there is no realistic hope for future success? Obviously, it should not. In making this decision, the firm realizes that the amount it has spent in developing the product is irrelevant; it should stop production of the product and cut its losses. In fact, many firms have dropped products after spending millions of dollars on their development.

A recent example is Pfizer's decision in 2007 to shelve its novel insulin inhaler because of poor sales and concerns about long-term side effects. The product withdrawal forced Pfizer to take a \$2.8 billion pretax loss on this highly touted product.

In short, if a cost has been incurred and cannot be partly or fully recouped by some other choice, a rational consumer or firm should ignore it. Sunk costs are irrelevant. Don't cry over sunk costs.

