

Sunk Cost

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Suppose the local theater is putting on a production of your favorite play. In anticipation of the event, you order tickets ahead of time for the second performance. Unfortunately, your best friend sees the play on opening night and tells you that it is awful and no one with any judgment would enjoy it. You now are in a bind because the ticket you purchased is nonrefundable, and you really do not want to see the play. What should you do?

Many people would go to see the play anyway, so as not to waste the price they paid for the ticket. This is a very natural psychological reaction that economists call “loss aversion.” People do not like to feel that they have spent money for no reason. However, natural as it may be, basing decisions on irrevocable past expenditures is a classic example of the “sunk cost” fallacy.

Economically speaking, a sunk cost is an expense that has already been incurred and cannot be recovered. For example, the theater ticket above is a sunk cost because it has already been purchased and cannot be refunded or easily resold.

Advertising expenses are another example of a sunk cost. Let’s say you invest \$1 million promoting a new product but find out that few people are interested in actually buying it. You could continue to pump money into hawking the good — not wanting to admit failure — or you could move on and promote a different product. Either way, you won’t be able to recover that initial \$1 million investment. It is a sunk cost.

Sunk costs are contrasted with incremental costs. An incremental cost is one that will change with a particular course of action. For example, when you are at the grocery store deciding what and how much to buy, the decision to purchase an extra loaf of bread involves an incremental cost. The expense of the bread will be incurred only if you decide to buy it.

A rational economic actor considers only incremental costs when making a decision. It makes no sense to factor in sunk costs precisely because they are sunk; no present action can change them. No matter what happens, the sunk costs are always there. In the theater example, you can either

go to the play or skip it. If you go, you will pay for the ticket and waste a few hours. If you do not go, you will still pay for the ticket and possibly spend the time doing something more enjoyable or productive. No matter what you do, you pay for the ticket so it makes more sense not to go and enjoy yourself instead.

Though the above example may appear relatively harmless, the natural human tendency to consider sunk costs in decisionmaking can have major policy implications. Just like people, businesses and government are often loathe to admit they made a mistake, cut their losses, and start anew. This tendency to hold on to failing programs too long may be especially acute in the public sector since the profit incentive is muted or nonexistent.

Ultimately, if a business refuses to admit it has made a mistake, it will go out of business or become significantly less competitive. Governments face little or no such competition to perform efficiently.

The United States is currently engaged in military action in Iraq — and there are strong arguments from many sides on how we should proceed. For example, some have argued that we should withdraw carefully from the region

now, while others maintain that we should stay until the area is fully stabilized. It’s not clear which side is correct.

What is clear, though, is that U.S. policymakers should weigh only the benefits and costs of leaving at the present moment. The time and money that have already been spent are sunk costs and should not be considered. It might be best for us to stay, but the fact that we are already there is not a reason for us to remain. To argue that we should finish what we started — no matter the consequences — would be to fall prey to the sunk-cost fallacy.

Costs are everywhere in life. Indeed, economics teaches us that they are unavoidable. So it is natural and rational to consider the costs of an action before proceeding. But we should be careful to focus on those costs we can affect at the present — and not on the sunk costs that we have already incurred. Focusing on sunk costs is ultimately counterproductive and can only be justified through our psychological prejudices. Still, the urge to do so is strong, and explains why the practice is common among both consumers and policymakers.

