

Rational Choice

Honoring Sunk Costs

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A Trip to the Inland Sea

You and a friend have spent a total of QR 10,000 for a weekend desert safari at the Inland Sea. When you arrive, conditions are rotten: it is hot, dusty, and humid. In addition, you and your friend feel lousy physically and out of sorts psychologically. Your assessment of the situation is that you would have a much better time if you just turn around and go home rather than stay for the entire weekend. However, you have already paid the QR 10,000 and it is non-refundable.

Question: Do you stay for the entire weekend, or do you leave for home?

A Night at the Movies

You have just spent QR 500 for your entire family to see *John Carter* in IMAX. Later that day, you spend QR 150 for your entire family to see *The Hunger Games*. You think that everyone in your family will enjoy *The Hunger Games* much more than *John Carter*. As you are putting away the *Hunger Games* tickets, you notice that *John Carter* and *The Hunger Games* are showing at the exact same time at completely different locations across town! It is too late to sell any tickets, and you cannot return any of them either. You must use one set of tickets and not the other, as your family wants to see the same film together.

Question: Which movie do you take your family to see?

Sunk Costs

Most respondents typically choose to stay and have a miserable weekend; most also typically choose to see the more expensive movie.

The reasoning is usually expressed in terms of **sunk costs**. That is, a person is more willing to do something into which they have already sunk (“invested”) more time, money, or energy—even though a better option is now available. People claim that they don’t want to “waste” these sunk costs.

Honoring Sunk Costs

A sunk cost is therefore a nonrefundable expense that a person has already paid. A person is then said to be **honoring a sunk cost** when they treat such an expense as equivalent to a current investment.

Notice the difference, however. A sunk cost has *no* net positive returns (it is nonrefundable, after all) whereas, in general, an investment in general may still have net positive returns in the future.

Examples

Finally, the day has finally come. You've got to think logically and realistically. Too much money's been spent, too many troops are over here, and too many people had too many hard times not to kick someone's ass.

- Sergeant Robby Felton, on the first day of Gulf War I.

We could not simply walk away from an enterprise involving two [presidential] administrations, five allied countries, and thirty-one thousand dead as if we were switching off a television set.

- Henry Kissinger, during the Vietnam War.

I have already invested so much in the Concorde airliner . . . that I cannot afford to scrape it now.

- Unnamed businessman.

Honoring Sunk Costs

Most economists and decision theorists believe that honoring sunk costs is irrational. Their reason for this becomes apparent when putting the options of these two choices into decision matrices.

A Trip to the Inland Sea

Bad conditions
at the Inland Sea

Stay the weekend

Lousy weekend on safari,
but spent QR 10,000

Go home

Good weekend at home,
but spent QR 10,000

A Night at the Movies

Family enjoys *Hunger Games*
more than *John Carter*

See *John Carter* Acceptable time at the movies,
but spent QR 650.

See *Hunger Games* Great time at the movies,
but spent QR 650

Honoring Sunk Costs

In both examples, no matter what you choose, you have already spent the same amount of money.

That is, the sunk cost is gone no matter what, and so economists believe that your decision should not be influenced by them. You should focus on the relevant *differences* between your options. This leads many economists to accept the criterion that decisions should only be based on future consequences.

Why Honor Sunk Costs?

Hal Arkes and Peter Ayton believe sunk cost reasoning may result from a person's tendency to overgeneralize rules for conduct such as “waste not, want not”. Studies show that young children (who are less likely to have internalized everyday truisms like “waste not, want not”) are less likely to demonstrate sunk cost behaviors than adults. So Arkes and Ayton conclude that maybe human adults are “too smart for their own good”.

Reframing Sunk Costs

The perceived problem of abandoning sunk costs may be ameliorated by refusing “to throw good money after bad”.

This puts the focus on the *present* going to the future (over which our decisions can influence), rather than the *past* (over which our decisions cannot influence). This also frames the abandonment of a sunk cost as *avoidance* of a sure loss (which is a good thing).

Example

The war situation has developed not necessarily to Japan's advantage.... In order to avoid further bloodshed, perhaps even the extinction of human civilization, we shall have to endure the unendurable, to suffer the insufferable.

- Emperor Hirohito, on Japan's surrender at the end of World War Two.

Next Class...

Exam #2 will be held in **lecture hall 2152** and begin promptly at 1:00PM. Show up and be seated by that time.

You are allowed to use one A4-sized page of notes (front and back). You will turn in that page of notes with your exam. Everything else (including cell phone) must put in the aisle or back of the room. Plan accordingly.

I will provide you with two pencils, one pen, a simple calculator, and plenty of scratch paper.