

Introduction to Business and Management

Spring 2020

- Economics Unit
 - Lesson #3

Daily Objective

Students will be able to define sunk cost and understand how to apply it to real world scenarios.

Lesson Starter:

Consider the following scenario and discuss how you would decide on the plan of action.

Scenario:

Initech is a large computer manufacturing company. Currently, Initech is trying to decide what to do with one of its old, large warehouses. The warehouse took over \$10 million dollars to build, but it has been abandoned for nearly 5 years. The company can spend \$3 million dollars to renovate the warehouse, or \$500,000 to demolish it.

What would you do?

Watch the video below, for further explanation

What is sunk cost?

In economics, a sunk cost is any cost that has already been incurred and cannot be recouped.



Link: <https://youtu.be/cdjd--57E9c>

Lesson Starter Continued:

In economics, sunk costs are irrelevant. Because they have already happened, they have no bearing on future decisions. So for our example, it doesn't matter if you spent \$1 or \$1 million on a warehouse. That money is gone. All that matters is the current cost of maintaining it, versus the potential benefit of renovating it, etc.

Does knowing this change your previous answer? Why or why not?

Activity: Sunk Cost Conundrums

In economics, sunk costs refer to costs that have already been incurred and cannot be recovered. According to economic theory, individuals should ignore sunk costs when making a decision. In economic terms, it is “irrational” to include sunk costs in calculations about future choices

Directions: In the next slides there are several scenarios. In each scenario someone is making a decision. You must decide if each decision is “**rational**” or “**irrational**” according to economic theory and **explain your reasoning**. Please record your responses on a piece of paper or Google Doc.

Scenario #1

James has been reading through the Harry Potter books for over three years. Currently, James is halfway through the last book in the series. After so many hours spent reading, James is a little bored with the story. Even though James is uninterested, he decides to force himself to keep reading and finish the book.

Rational or Irrational? Why?

Scenario #2

Sharon has been saving money for a vacation for the past 3 months. She already has her non-refundable plane tickets and hotel reservations purchased. Everything is going according to plan until she gets a call from her friend Sam. Sam is getting married on the same weekend as Sharon's trip. Sharon decides the wedding is too important, so she cancels her plane tickets and hotel reservations, losing over \$2,000 in the process.

Rational or Irrational? Why?

Scenario #3

Gabriel is writing a research paper for class. Hoping to finish quickly, Gabriel picks a topic without doing any research. After four hours of work, Gabriel realizes he is stuck. His topic is too complicated and the paper is becoming too difficult to write. Gabriel could tough it out and finish his paper or he could start over with a brand new topic. Gabriel decides it will be easier to start from scratch.

Rational or Irrational? Why?

Scenario #4

Kim owns her own business, Kim's Cars, a used car dealership. Kim's company has been doing extremely well; however, very few people have heard of her company. On the other hand, almost everyone has heard of Kim's competitor, Tom's Trucks. Kim's business is so successful that she has enough money to buy Tom's Trucks. With two different stores, Kim has to decide on a new name. Should she change both stores to Kim's Cars, or should she rename both stores Tom's Trucks? Kim decides she likes the sound of her own name, and decides to name both stores Kim's Cars.

Rational or Irrational? Why?

Practice Outside of the Lesson:

Outside of this lesson, I encourage you to reflect further on your own experiences. Have you ever been in a situation where you stick with a bad plan simply because you've invested time and energy in it? Why weren't you able to forget about sunk costs?

I encourage you to keep the concept of sunk cost in your mind for future decisions!