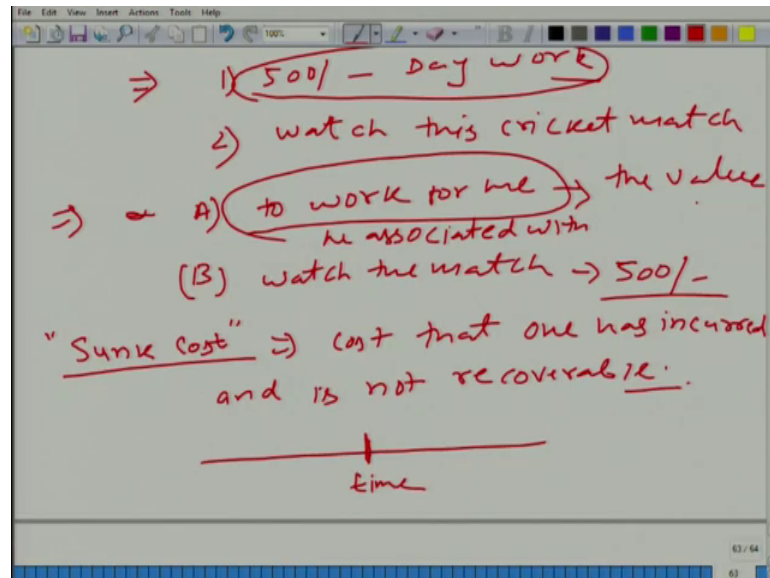


An Introduction to Microeconomics
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Lecture – 88
Economic Terminology: Sunk Cost

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Second; I talked about concept is sunk cost what is sunk cost?

Student: The cost that we cannot [FL] we cannot get back that is totally lost.

Totally lost where.

Student: Means that cannot be reimbursable.

So, it is basically it is the cost that one has incurred and is not recover[able]- the cost that cannot be recovered. For example, let us say although everyone is coughing at that idea people are not very happy about it let us say for example, someone prepared for j e joint entrance exam to get admission into 1 of the ITs. And he paid let us say 50000 rupees for coaching and he did not clear the j e he cannot recover this 50000 ok. Even if we cleared j e.

Student: (Refer Time: 01:41).

The second scenario what would be the in the first case its clearly the sunk cost. 50000 rupees is the sunk cost for the person who did not clear the j e how about the second person who cleared the j e?

Student: It would be more of an investment than an expenditure for him it would be a sunk cost.

It is sunk cost because it is no longer recoverable.

Student: But he is getting the value out of it.

But that is a different thing; when we are talking about when let me ask you another question I say how much is the cost of this pen? Do you start talking about how much the value you have for this pen? No the question is very simple; how much is this cost the cost you should not this is the major problem when you talk about cost keep the revenue or the benefit that you are getting out of it, cost is different from benefit. The sunk cost is the same because it cannot be recovered, it is a different thing you know even first I was willing to first I spent that person who did not get into j e at that time he had some expectation that he would clear.

So, he made it was you know at that point of time it was a valuable investment for him, but nevertheless at this present moment. Whenever we are talking about sunk cost you have to think where at what time you are talking about, the time t and this time this cost is no longer recoverable that is why it is sunk cost.

Student: Would does that mean every expenditure is a sunk cost?

Not necessarily if for example, that let us say you have spent 5 rupees for this pen let us say this is the pen and you have spent 5 rupees for it. Now can I recover some money out of it?

Student: Yes sir.

If I sell it let us say maybe may not in the market, but in hostel or somewhere, there is some willing buyer who would buy this pen, let us say for 4 rupees 50 paisa in this case my sunk cost is only.

Student: 50 paisa.

50 paisa; 4 rupees 50 paisa I am able to recover it. So, that is not the sunk cost.

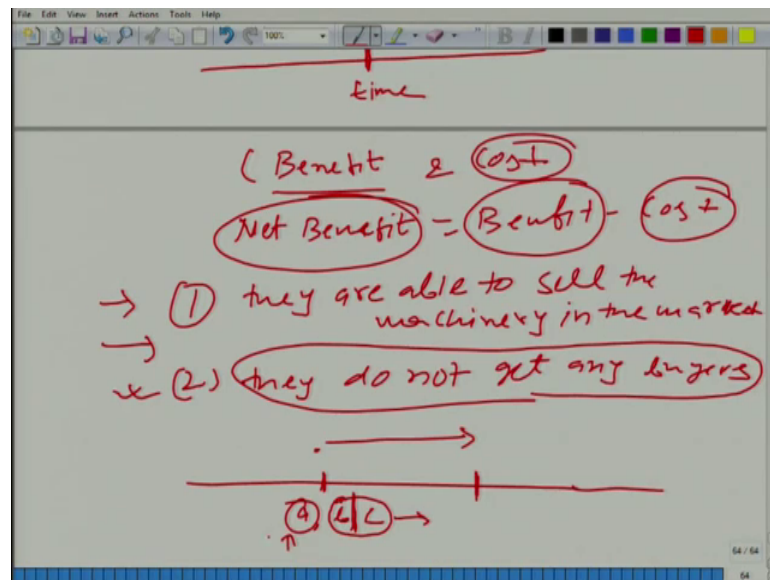
Student: But sir then looking in that way someone clears j e, he has probably a brighter future than the other guy it is a;

That something again benefit we are not talking whenever.

Student: Only in monetary terms you are saying.

Even in any term you are whenever you make decision I am not talking about it right now, but let me make it very very clear to you.

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Whenever you talk about a decision, you think about benefit and cost and net benefit and that is net benefit is benefit minus.

Student: Cost.

Cost. I am talking about this component this component, I am not talking about benefit or the net benefit you always keep it.

Strident: Separate.

Separate for example, you bought a machinery, let us say we have a setup here for recording that is taking place, and the machinery cost let us say 5 lakh rupees when this

project is over NPTEL project is over, let us say there can be two things either they are able to sell the machinery in the market and second is that they do not have they do not get any buyers.

In this case complete 5 lakh rupees at that point of time.

Student: Sunk cost.

Is sunk cost because it cannot be recovered back of course, you will have to account for depreciation and all because machineries are must they used this machines for some time.

Student: So, sir the services they are providing are not included in this.

Again services is a benefit that they are providing.

Student: Sort of they are they are not included.

They are not included we are talking about the cost let us say there is no depreciation in that case, sunk cost would be the complete amount. But let us say there is a 10 percent depreciation every year and the project is over in a 1 year, then 4 lakh 50000 is a sunk cost, it is gone.

Student: Sir.

Yes.

Student: One more thing sir, if like if this 5 lakh rupees is spent on all the gadgets ah, but this 5 lakh rupees can be kept in a bank also. So, he might be gaining some interest on that. So, sir would that interest be included in the sunk cost also if they do not find anybody.

No, no that would be the opportunity cost of buying the machinery.

Student: It would not be included in sunk cost.

Sunk cost.

Student: Sir, but why we could not recover the; that interest also.

No, but you have used you have bought them see we want to keep things simple, if we keep on adding things it would become too complicated. The sunk cost here is very simple that these machineries cannot be sold again ok. I am again taking care of that depreciation.

Again you bought this machinery because that was the best use.

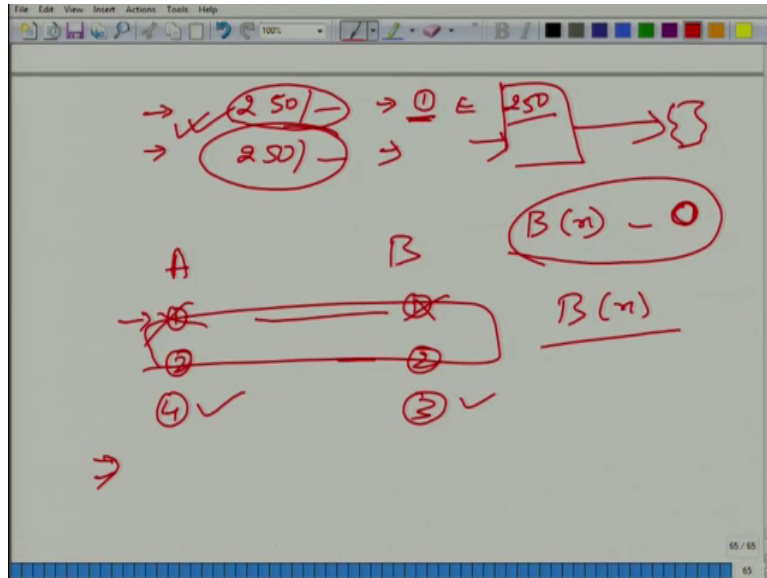
That is why you bought the machinery. So, we are not talking about the second best; second best we are talking about when in case of opportunity cost you have already made the see this is why time is quite important. You hear you have let us say option a b and c and you go for option a, because this is the best option. Now you want to get the opportunity cost of going for a, then what you need to do? You need to figure out that which is the better 1 between b and c you figure out b what would have been the value added to you, if you had opted for b and that would be your opportunity cost because you did not opt for B that is one thing, but here you have opted for decision A.

And so, you have been invested let us say something and you are here at this time you are here there is no sunk cost at this point. Now here you in the time when the you bought some machinery or something, at this point you are not able to sell this machinery. So, what you have money that you have spent for a? Let us get forget about any depreciation or that would be your sunk cost because it is no longer recoverable fine.

So, the money again going back to there in the j e coaching, once you have given the j e exam once you have paid the money and the refund period is over, that money is sunk cost, right.

Let us take one more example let me ask you a question.

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Let us say all three of you decide to go for A for buffet and you have to pay right in the beginning 250 rupees.

Student: Ok.

And you can eat as much as you want whatever they have you know all the items you can eat as much as you want dream for you guys fine ok. So, then this is one case. The second case is that mister A, let us say in this case the A is very happy because he won some price, and he takes two of you for the same buffet you know the buffet that I was talking earlier and he pays 250 rupees for each of you.

Student: Ok.

Now, let me ask this to you and you are of course, not the wish grabber. So, in which case you would eat more?

Student: In the first case.

In the first case you will eat more because you have paid 250 rupees how about you?

Student: Second case

Second case because your friend.

Student: I am not paying anything.

Student: Not paying anything for it.

But you will eat more that because you are not paying anything. So, you will eat more?

Student: No

Think about it again what do you do in such cases”/

Student: I eat in the first case I will eat more.

You will eat more in the first case typically that is the response I get that is why I said.

Student: But practically in the.

Now, let me ask you.

Student: Eat.

Why would you let us say it was not Dinesh who was paying for you let us say that Babcock paid for your buffet and in the first case you paid for your own buffet, in which case you would eat more?

Student: In the first case.

First yes and what is the reason let me ask all three of you the reason why let me start with you.

Student: It is because when I am paying from my pocket, I feel the worth of it more than someone when someone else is paying for me.

Ok.

Student: So, I would try to utilise I would try to maximise my utility for that.

Ok you are trying you are using big words maximizing utility and you have learned it in this course good let us see how about you.

Student: Sir because in the first case 250 rupees is my sunk cost.

Do not do not use the sunk cost.

Student: Ok.

You know just think about me you do not know any economics, but you would do this.
So, why?

Student: He may repay it sir because of the same reason because if I am paying those 250 rupees.

You want to get bank for your buck more as much as possible how about your same thing.

Student: Almost same.

But now let us see on this there is a gate and here is the restaurant at gate you got a ticket, you paid 250 rupees does not matter you paid, he paid does not matter now you are eating what is your cost? When you take let us say you we are talking about eating more, let us say at any point of time you are deciding you know that whether I should go for one more [FL] what is your cost at that point.

Student: 1 nothing 0.

Zero 0 it has been all paid for. So, your cost is nothing and your benefit is, we do not know exactly how much is your, but you have some benefit; will the benefit remember the way we are talking about it the way he has been messing up that is a different thing, but the way we are talking about will the benefit change I am not talking about the net benefit I am talking about the benefit independent of cost benefit.

Student: (Refer Time: 12:24).

That you have in your mind that does not depend on the cost will the benefit change.

Student: No.

If you pay pick you if you had paid in the beginning or someone else had paid for you in the beginning.

Student: I think it would change.

How?

Student: because if I have paid I would gain more pleasure while eating that food than someone else has paid. Because if it is my; if it is not it is in my mind that I have actually paid. So, I get I could gain the maximum benefit by eating it.

You are really a weird person let me tell you.

Student: Sir, it is the other way round.

Other way around it happens typically.

Student: By when it is paid by someone else you get more pleasure.

You get more pleasure typically that is a typical perception.

Student: We have.

We have.

Student: Yes sir.

That if someone else pays you get more benefit ok, but I am not talking about it, but the way we are framing it does not matter, it does not matter typically you know the way a rational person should behave that is you know at the way a rational person should behave these two conditions are the same. In both the cases if you now go back to the definition, the 250 rupees in both the cases are sunk cost you are not going to recover. The cost is that you have already incurred whether you walk out of that restaurant or you eat more it does not matter this is the sunk cost.

So, if you are deciding about it you should not consider this sunk cost what we are talking whenever you make decision I although I have deviated a little bit from the sunk cost because this is a nice example that, whenever you have this sunk cost you should not consider any sunk cost in your decision making what you should consider in decision making?

Student: Benefits.

The cost that let us say, now you have two accents and there are 1 this is common, 2 is common, here we have 4, here we have 3. You should not talk about 1 1 because it is the same its not varying with the decision, you should only consider 4 and 3, what varies

with the decision should be considered while making the decision. So, sunk cost does not vary in both the cases. So, you should not bring sunk cost while you make some decision.

Student: Sir, but how if he is paying 750 rupees then its 750.

He has already paid he has already paid the 750 rupees.

Student: But it is his sunk cost if I have paid in.

It does not matter it is his.

Student: Mu sunk cost is 0 [FL].

Or yours.

Student: Ok

When you are making when you are eating that extra [FL] you have some benefit associated with it the cost of having that [FL] is 0 whether he has paid for it or you have paid for it in the beginning. So, your benefit is in the both case b of x . So, you should behave in the same.

Student: Same way.

Fashion in both the cases; so, you should never consider sunk cost while you make a decision whether it is his or yours you should always ignore the sunk cost because its already gone. Now let us say one more example because this is very big problem when we make you know sometime people one other example let me give you that when you go for go to watch a movie, and after 10 minutes or half an hour you realize that the movie is very boring. Sometime you say, but I have already paid for it let us sit and watch this movie, the problem is that you should not consider the amount that you have paid right in the beginning because that is already gone.

Whether you watch the movie or you come out of the cinema hall you are not going to recover that cost of the ticket that is the sunk cost. So, of course, it depends on your level of pleasure you want to continue or you want to come out, but you should never give this

fallacious argument, because we have already paid in the beginning let us sit and watch, but that is already gone.

Student: (Refer Time: 16:44).

It is not going to vary in both the decisions you understand.