



# Cornhusker Economics

## Don't let the Past Sink Your Future

The last station wagon my parents purchased, and the only one I really remember was a 1989 Chevrolet Celebrity Eurosport. The vehicle didn't look like it was European, it wasn't sporty, and it certainly wasn't driven by celebrities. It did, however, have some unique features. Despite having the "Eurosport" package, it was powered by 110hp 4-cylinder engine. This engine was underpowered in its smallest application and was certainly no match for a 7-passenger wagon. Thus, whenever the engine was taxed, the air conditioning automatically cut out. Surely this was a feature to provide extra safety when passing on two-lane roads. Another "safety" feature developed early in the car's life; only first and second gear would work. This functionally limited the car to 40-45 mph, ensuring we'd never be involved in a high-speed crash.

This particular vehicle would have its transmission replaced three times under warranty. Perhaps the only person more upset than my dad was the service tech. While my dad's frustration properly taught me how to string together four-letter words, it also taught me about an important economic concept, sunk costs.

Economics, like many other professions, has its own lingo/jargon. What makes economics jargon different than others, is that it is relatively innocent sounding. For example, fixed, overhead, ownership, indirect, and sunk costs are all used within economics; often used interchangeably. While the first four are truly synonymous, sunk costs have a specific feature that makes them especially important for managers to consider.

Fixed, overhead, ownership, and indirect costs are all costs that businesses incur that do not increase or decrease with production. Insurance policies, rent, taxes, advertising, and depreciation are all examples of these types of costs. Typically, sunk costs are of this variety. Put another way, sunk costs are almost always fixed, but fixed costs are not always sunk. A sunk cost is a cost that has happened in the past and cannot be reversed.

Decision scientists have many algorithms for making decisions. These algorithms can be qualitative and subjective, such as following a 7-step process, to highly quantitative procedures like minimax regret, or linear programming. These techniques are very different from each other, but in one way they are very similar; they never, ever suggest the manager become emotional and use past decisions to guide the future.

Past decisions and events *should* guide decision-making. They help managers assign probabilities as well assessing performance. Viewing these events and situations as permanent paths is where sunk costs become problematic. Think about the following four scenarios:

### Scenario #1

On a family road trip, you encounter traffic. Traffic grinds to a halt, and there are four lanes to choose. The driver chooses the most leftward lane, rationalizing it is the "fast lane." Unfortunately, the other three lanes seem to move, while your lane is stuck. Despite your pleas, the driver sticks to the "fast lane" decision.

### **Scenario #2**

You purchase a super-automatic espresso machine for your significant other. Both of you love coffee and buying a commercial grade super auto seems like a good idea, even if a basic example costs \$1000. After several months of use, you realize the machine requires 6-8x as much coffee as your drip maker, and only specific beans work. Additionally, only proprietary filters work, and they must be replaced more often than you anticipated. Despite these shortfalls, you continue to use the machine.

### **Scenario #3**

A friend suggests you invest in the stock market. They provide a “tip”, and you invest \$10,000 at a price of \$20/share. Over the next year, the price of the stock fluctuates between \$16 and \$20, while the rest of the market takes off. You would like to invest in other stocks, but do not want to liquidate your original investment until it is in the black.

### **Scenario #4**

Your business invests in a large piece of specialized equipment. The purchase price of the equipment is \$500,000, which is financed with a \$400,000 loan and \$100,000 cash. The loan is amortized over 10 years. After 5 years, the loan balance is \$225,000. While the investment in equipment has not cost the business money, it has not been as profitable as expected. At the same time, a piece of adjacent land goes up for sale. The business has eyed the property for some time, and the timing of the sale is unexpected. You consider selling the equipment purchased previously to finance the land purchase, decide against the sale as doing so because you initially invested \$100,000 in the equipment, and selling now would result in a loss of that equity.

These four scenarios all highlight decision-makers’ emotional connections to decisions made in the past. Changing lanes, buying a new coffee maker, selling a poorly performing stock, and liquidating equipment would all affirm the decision-maker had made a mistake. Tragically, these mistakes compound others. While waiting in traffic a few extra minutes is hardly an issue, passing on buying adjacent land could have epic consequences.

In the end, my dad traded the Celebrity for a Chrysler minivan, days before the original warranty expired. He

was sure the next owner would have the best used vehicle on the road as everything had been replaced. When I asked my dad if he regretted buying the Celebrity. His reply, “Yes, but not as much as I regret keeping it.”

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