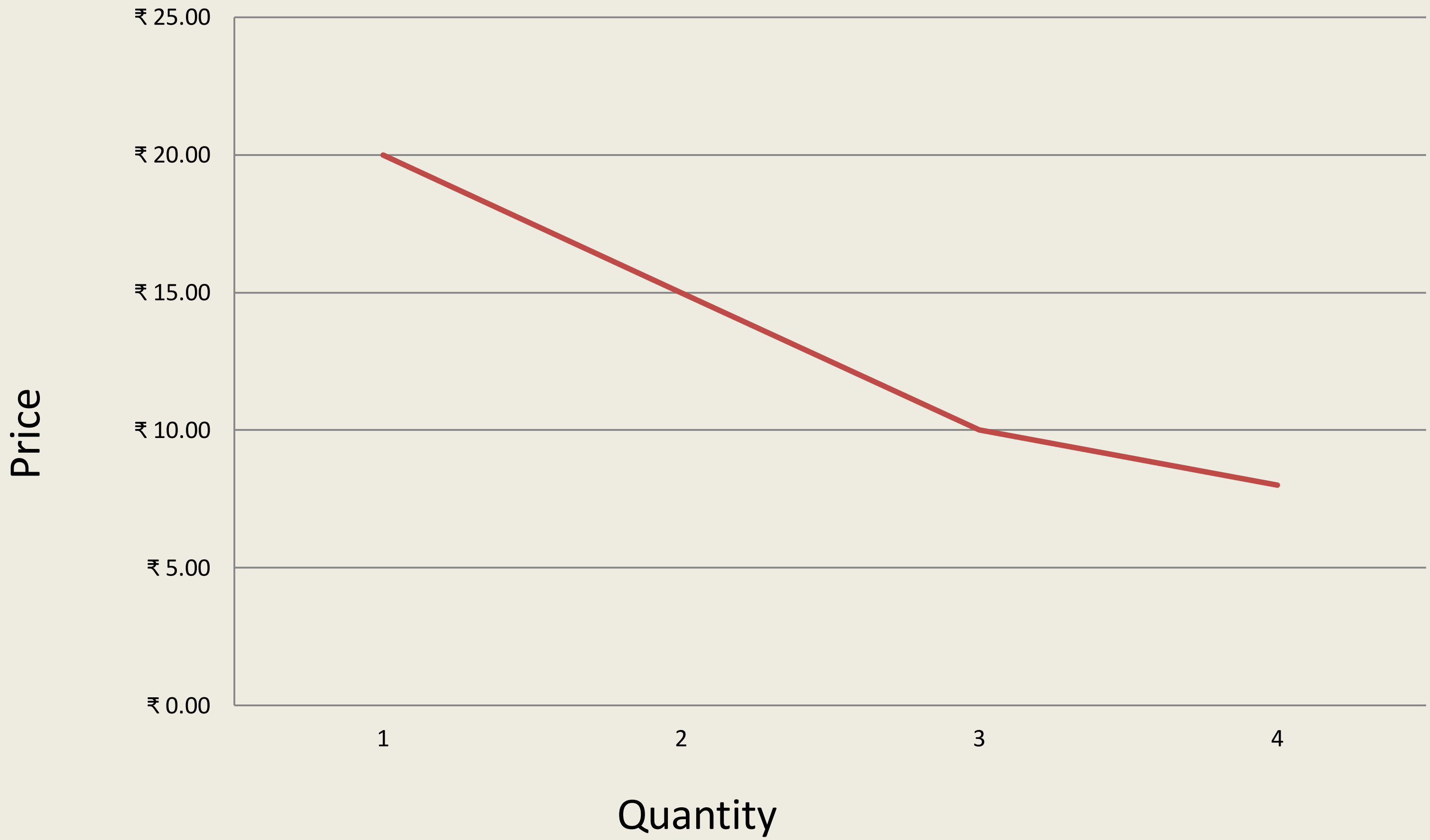
Costs - Fallacies - BEA

Praveen Malla

Consumer Surplus

Value consumers get from a good but do not have to pay for



Opportunity Cost

Benefits of the first alternative are larger than the profits made from the second alternative

- Decision: Choose first alternative

So the 'opportunity cost' of one alternative is the foregone opportunity of making profit from another.

- Example: Assume MEC has additional classrooms
  - Extra classroom – no occupancy
  - Cost of managing the extra classroom – Rs. 20,000 per month
  - It has an opportunity to rent the room for Rs.20,000 per month. What should it do?

Sunk Cost Fallacy

- Occurs when you consider costs and benefits that do not vary with the consequences of your decision.

- You make decisions using irrelevant costs and benefits.

  – Tug along with your friend in her car

    (what if she asks for money at the end of the ride?)

  – Buy a cricket match ticket for Rs.1500 and halfway through you realize your team is badly losing

    (what would you do?)

Sunk Cost Fallacy – Some Examples

Imagine you have gone on a date. Spent about Rs.3000. While still eating in your favourite restaurant you realize that the date is not a good match for you.

What would you do?

- Assume MEC owns 10 buses.
  - MEC incurs Rs.10 per km if it uses its own buses to ferry its employees
  - A smart manager like you checks out what the price would be if the bus service is outsourced and finds the cost to be Rs.8 per km
  - What should MEC do?
  - **Accounting profit is not equal to Economic Profit**

Hidden Cost Fallacy

- Occurs when you ignore relevant costs
  - Costs that do not vary with the consequences of your decision

- For example:
  - You are a working professional earning Rs. 100 per hour.
  - A friend comes to you and says that he has an extra movie ticket and offers it to you for 50% of the ticket price. Ticket price for you is Rs.200.
  - You are not a big fan of movies yet you buy the ticket.
  - Once you have bought the ticket what would you ideally do?
    - Watch the movie or go back to work?

Breakeven Analysis

- Breakeven = No profit, no loss
- We all know that organizations incur fixed costs and variable costs.
  - – Fixed costs do not vary with quantity produced
  - – Variable costs vary with quantity produced
    - Marginal cost = cost incurred to produce that extra unit of product/service
    - So marginal costs vary with quantity produced

    - Breakeven quantity = Fixed Cost / (Price – Marginal Cost)