I. Background: Basic concepts from economics

A. Opportunity cost

• The opportunity cost of any decision or action is the value of the next best alternative that the decision forecloses. For normal money transactions, this is the same as “cost” in the ordinary sense:

Example 1:
• What you give up when you hand over $30 for a concert ticket is the $30, and the next best thing you would have spent the $30 on.

A. Opportunity cost

Example 2:
• A young woman with a high school education and a great serve has the choice of becoming a tennis pro or work on an assembly line, earning $16,000 per year.
• If she cares only about the money, the opportunity cost for her to become a tennis pro is the $16,000 she gives up, and she should do it if she can earn more than $16,000 in tennis.
• But suppose she has the skill to be a tennis pro earning $100,000. Then if she decides to work on the assembly line, or maybe enlist in the army, her opportunity cost of doing either of those things is the $100,000 per year that she can earn as a tennis pro.

A. Opportunity cost

Example 3 (Includes non-monetary considerations):
• The opportunity cost for the tennis player to turn pro is $16,000 only if:
  • $16,000 is what she could earn in her next best alternative job, and
  • she is indifferent between the two jobs apart from the levels of pay.
• If playing tennis is so much fun that she would gladly sacrifice $4,000 per year in cash for the privilege of playing tennis rather than working on the assembly line, her opportunity cost to play tennis would be $12,000, not $16,000.
• If tennis is so demanding that she would need an extra $10,000 to accept the discipline and hard work, rather than work on an assembly line, what would her opportunity cost be to play tennis?

A. Opportunity cost

About Example 3:
• Only she can judge the appropriate level of payment for her to take one job rather than the other. It is subjective, not objective.
• No outside observer can tell whether she is making the right choice.
• If she chooses job A at $12,000 when she could have also had job B at $16,000, an outsider can infer that the extra benefits from job A are worth (at least) $4,000 to her, if she didn’t make a mistake.
• If she chooses job C at $25,000 when her alternative was job B at $16,000, we can infer that any extra benefits from B relative to C are worth less than $9,000 to her – again if she didn’t make a mistake. But we can’t tell if she made a mistake.
A. Opportunity cost

- Example 4 (Only non-monetary considerations):
  - Suppose you have to choose between watching a football game on TV and watching a movie at the same time on another channel.
  - The opportunity cost of watching football is missing the movie, and the opportunity cost of watching the movie is missing the football game.
  - You would want to pick the one with the (lower / higher) opportunity cost.

- Example 5
  - What is the opportunity cost of attending the University of Minnesota?

B. Economic Profit and Accounting Profit

- The professions of accounting and economics have grown up using two different definitions for profit.
  - For an economist, profit = revenue minus opportunity cost.
  - For an accountant, profit = revenue minus financial costs paid to non-owners.
  - Opportunity cost of owners’ capital, the risk they take, and the time they put into the business is included in accounting profit, not in economic profit.

B. Economic Profit and Accounting Profit

- Example 1: Corn farmer
  - The opportunity cost to the farmer includes:
    - the opportunity cost of his own time
    - the opportunity cost of his own capital invested in the farm
    - the return to his risk-taking.
  - So a farmer that earns zero (economic) profit is still being fully compensated for all of his work, his capital, and his risk-taking.
  - A farmer that earns zero accounting profit is not compensated for any of those.

C. Lerner, Ch. 1: Economics is about people

- A definition of economics:
  - Economics consists of studying how all the things that people in general want are produced and made available to them, and how this might be done better. (Lerner, p. 4)
    - “People in general” means that economics does not (often) concern itself with particular individuals, as psychology does.
    - Not concerned with the technology of production (that is engineering).
    - Concerned with whether production is efficient (not wasteful).
  - But, more important, concerned with whether the right things are being produced.

Lerner, Ch. 1: Economics is about people

- Most of the decisions a society makes about
  - what will be produced and
  - who will get it
  - are decided through markets.

- Markets are the institutions that lead to setting of prices and delivery of goods.
- So a lot of economics consists of understanding how markets work, and why they sometimes fail to work well.
- But markets are important only as a tool that people in general use to help achieve their wants.
Economics is about people

- Government, too, is significant only as a tool that people in general use to help achieve their wants
  - often as a substitute for markets where markets don’t work well,
  - often to interfere with the operation of markets, trying to make them work better, or
  - to transfer income from one group to another.

Opportunity cost v. accounting cost

- Two differences:
  - Opportunity cost will include subjective elements (if relevant) as well as financial costs
  - Accounting cost measures financial costs only.

And

- Opportunity cost includes costs to owners of a firm
  - Accounting cost does not.

- Most of you got 1st, not 2nd.

C. Lerner, Ch. 2, 3: What is a fair price? What is the correct price?

- “Fair” depends a lot on what you’re used to (e.g., fuels).
- Is the size of profit a good test for what is fair? No.
  - Example 1: Suppose I rent my oil land to you. If the price of oil doubles, I’ll double the rent. Your profit won’t go up. The value of my oil land doubles. My rent payments will go up in dollars, but as a % of the value of assets it won’t go up.

What is a fair price?

- Example 2: Suppose I produce the oil myself. If the price of oil doubles, the value of my oil land doubles. My profit will go up in dollars, but as a % of the value of assets it won’t go up.

What is a fair price? What is the correct price?

- Economists don’t judge prices on whether or not they are fair. They judge them on whether or not they are efficient.
  - “the purpose of prices is to help our economic system make available to every consumer what he prefers without diminishing the satisfaction of other consumers.” (Lerner, p. 9)

Pause to honor Vilfredo Pareto (1848 - 1923)