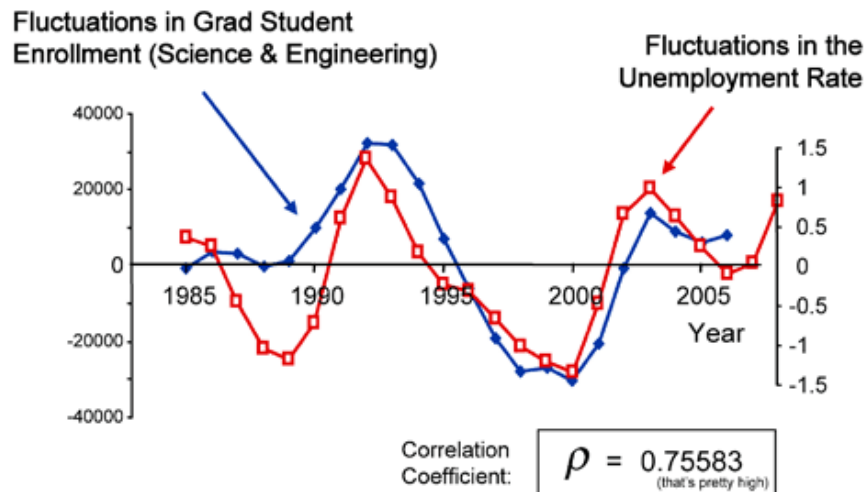


LECTURE 04: OPPORTUNITY COST

- I. Where do prices come from?
 - a. Last class we discussed how market prices overcome the twin problems of knowledge and incentives. Because prices are so important to understanding economic activity (and to our everyday lives), it's worth discussing where they come from.
 - b. Let's begin with the wrong answer: the *labor theory of value*, which is a foundational idea in Marxist thought. It states that the value of something is determined by the average number of labor hours to took to produce it, thus work equals value.
 - i. With just a bit of thinking, it's clear the labor theory of value makes no sense: a person can spend a long time poorly sewing a shirt, but that shirt would not be worth more than a shirt quickly sewn by a master. Hard work does not automatically mean more value.
 - ii. This leads to an often-unappreciated point about capitalism. At its core, capitalism does not reward "hard work." It is not even a "meritocracy" (nor does not claim to be). Capitalism rewards value creation; while hard work and value creation are often correlated, they are distinct concepts.
 - c. The correct answer to the question lies in the *subjective theory of value*, which states that value derives from how much buyers and sellers like the item. All value is subjective; even intrinsically valuable things like electricity differ in the magnitude of their value from person to person.
 - i. The "inherent qualities" of the good or service thus don't matter. What matters is how people value the final product.
 - ii. For example, women's basketball players earn much less than men's basketball players even though WNBA players are arguably better at teamwork and fundamentals. Subjectivism explains much (or all) of the pay gap: the NBA is much more popular. For whatever reason, far more basketball fans prefer to watch the NBA over the WNBA.
 - d. Prices are thus *discovered* through the repeated interactions of hundreds or thousands or millions of buyers and sellers, and thus aggregates countless preferences knowledge.

- i. Because prices aggregate so many considerations, we can say that prices measure scarcity. This concept extends to wages as well, as wages are just the price of labor. Why do some people get paid more than others? Because some labor is more scarce than other labor.
 - ii. For the resulting prices to incentivize efficiency, the markets must be competitive. As we will discuss at the end of this unit, markets are not always competitive because of laws that restrict entry. Many criticisms of capitalism boil down to criticisms of these laws.
- e. Why do people value things as they do? This is obviously a big question, one that easily spills into psychology, so economists tend to avoid commentary about why people value what they do. *De gustibus non est disputandum*. (“In matter of tastes, there can be no disputes.”) In other words, there’s no accounting for tastes. We take tastes as given and go from there.
- i. That said, there are economic insights into why preferences are what they are and we turn to that now, beginning with another big idea in economics: opportunity cost.

II. Consider this diagram:



- a. Trade-offs are everywhere: it is a consequence of choice. For everything you choose, there is something you must give up.
- b. This is the *opportunity cost*—the gain of the next best option.
 - i. When the opportunity cost is high, that means you are sacrificing a lot; when it is low, you are sacrificing little.
 - ii. In that way, they are costs in the truest sense. Indeed, all costs are really opportunity costs. When you buy something, it

doesn't cost you the money you spent. It cost you what you would have spent that money on.

- c. When someone has a high opportunity cost to do something, they have to be compensated to make it worth it. Thus it's hard to hire engineering and nursing professors because they can make a lot of money doing the job they're trained for. It's easy to hire art professors—being a professional artist doesn't pay much on average.