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ECON 201—Montgomery College

TOPIC 02: OPPORTUNITY COST

I. **Fundamental Idea Two: There are always opportunity costs.**

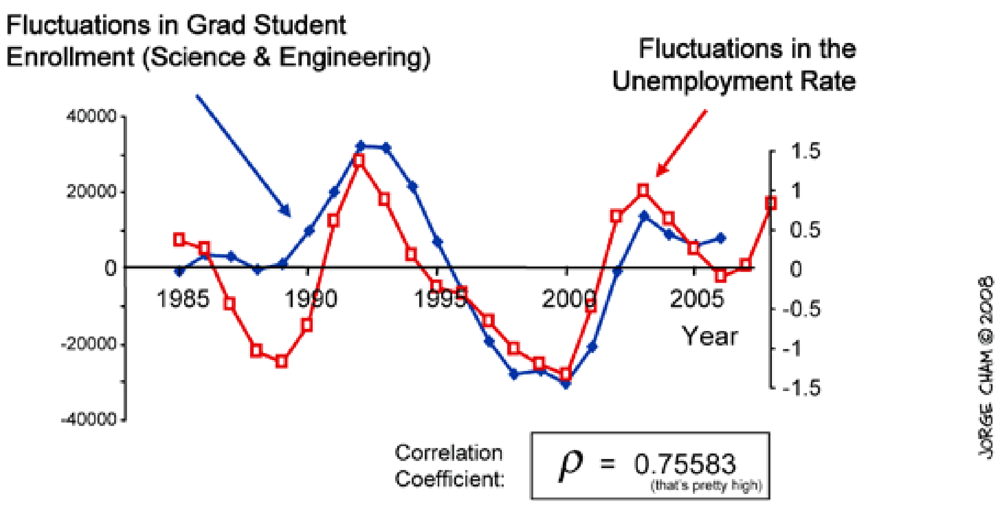
a. Because we deal with scarce resources, we have to make choices. Whenever we choose one thing, we give up something else we did not choose.

b. *Opportunity cost*—the gain of the next best option.

i. Keep in mind that an opportunity cost is a *forgone benefit*. The opportunity cost of doing something is a good thing you *did not* get to do.

ii. When the opportunity cost is high, that means you are sacrificing a lot; when it is low, you are sacrificing little.

iii. Consider this diagram about the relationship between unemployment and graduated school enrollment. There's an opportunity cost story here explaining the strong correlation; what is it?



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—the average pay of a professional artist is pretty low.

d. It's worth mentioning the *lump of labor fallacy*, or the tendency to think that there's a fixed amount of work.

i. People are sometimes concerned that robots or trade or immigration will result in fewer jobs everyone. But that is a fallacy—there's nothing to suggest that fewer jobs in one sector results in fewer jobs for the whole economy.

   ii. Labor is a scarce resource and that means there are always opportunity costs. People doing work in one sector aren't doing work in something else. Moreover, efficiency gains from robots/trade/immigration means some jobs are possible that weren't before. For the vast majority of human history, virtually everyone was a farmer; our ancestors would be astounded at the jobs people have now.
   iii. This doesn't mean macroeconomic disruption is never painful. Retraining and relocating are difficult and for some it is impossible. Even when society as a whole benefits, we should never assume that progress never has victims and that leads us to…

II. **Fundamental Idea Three: "There are no solutions. There are only trade-offs."**
   a. This quote attributed to economist Thomas Sowell points to the fact that economists don't think in terms of X will solve everything, or Y is always the right answer. There are always trade-offs. We can think of this fundamental idea deriving from the previous two.
      i. <u>Incentives</u>: If something was universally better than everything else, it would've already been adopted.
      ii. <u>Opportunity cost</u>: Getting a good thing always comes at the expense of other good things.
      iii. Another favorite quote of mine, this one by economist Frank Knight: "To call a situation hopeless is equivalent to calling it ideal." Quotes like these are why economists are often not invited to the cool parties.
   b. The *Nirvana fallacy*, or the tendency to compare an actual thing to an idealized fiction, comes up a lot here.
      i. People will complain about some aspect of the status quo without seriously considering the alternatives. They see something they don't like and pretend their ideal option is possible. As the saying goes, "the perfect is the enemy of the good."
      ii. <u>Example</u>: During the 1970s, environmental groups protested nuclear power plants in favor of solar, wind, or just lowering energy consumption. These were unrealistic alternatives so when environmentalists successfully blocked nuclear power, coal and natural gas power plants expanded instead. Whoops.

c. That there are always trade-offs doesn’t mean that there aren’t bad options or good options. As cost-benefit analysis reminds us, sometimes what we gain is far better than what we lose. Opportunity costs can be high or low.