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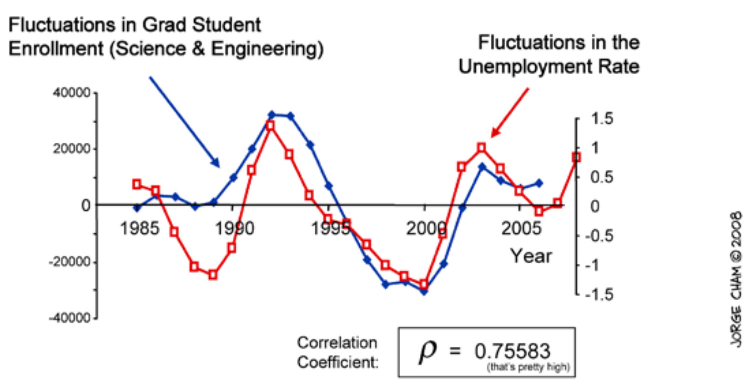
ECON 202—Montgomery College

LECTURE 02: TWO BIG IDEAS

I. Two things
  a. Economics has two foundational ideas.

II. One: incentives matter
  a. This is because people are *rational*—choosing the best action given their preferences and constraints.
  b. Because incentives matter, choosing the right incentives changes everything. This has enormous implications for policy and economic development.
  c. The institutions, the rules of the game, should align self-interest with social interest.

III. Two: there are always opportunity costs
  a. *Opportunity cost*—the net gain of the next best option.
    i. Note this is net gain: include the costs as well as the benefits.
    ii. When the opportunity cost is high, that means you are sacrificing a lot; when it is low, you are sacrificing little.



  b. Accounting framework
    i. Benefit – Expenses = Accounting Profit
    ii. Ex: If I make $50 selling apples and it costs $40 bringing them to market, my profit is $10.
  c. Economic framework
    i. Accounting Profit – Opportunity Cost = Economic Profit
    ii. Ex: If, instead, I could have spent $45 selling candy apples for a total of $60, my opportunity cost is $15
    iii. Since $10 – $15 = -$5, I have negative economic profits. In other words since I could have made more selling candy apples I actually made a loss. My opportunity cost was high.

IV. Applications

a. Are hurricanes good for a local economy? Are wars?