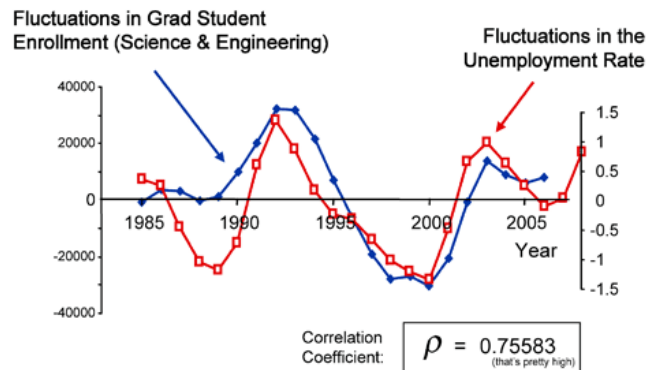


## LECTURE 02: TWO BIG IDEAS

- 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 – Cost = 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?