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TOPIC 02: TRADE-OFFS

I. **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. Incentives: If something was universally better than everything else, it would've already been adopted.

ii. Opportunity cost: 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 parties.

b. The *Nirvana fallacy*, or the tendency to compare an actual thing to an idealized fiction, comes up a lot in this context.

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. Example: 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. Sometimes what we gain is far better than what we lose. What we need is a framework to think about the full benefits and the full costs of some decision.

II. Cost-benefit analysis

a. *Cost-benefit analysis*—a process of weighing the total costs of an action against the benefits of that same action and proceeding if benefits exceed costs.

        i. This sort of analysis sometimes seems too obvious to need to be pointed out but it serves as a helpful guide. Certain policies or events carry so much emotion that we forget to weigh the costs against the benefits.

b. While cost-benefit analysis can seem obvious, it has some unexpected insights. For example, the Vince Lombardi line "winners never quit and quitters never win" doesn't exactly ring true in economics because of the existences of sunk costs.
c. *Sunk cost*—a cost that cannot be retrieved. Such costs incurred—such as specialized equipment which can't be resold—shouldn't be a factor in decisions since that money is lost regardless of what you do.
d. This is noteworthy because people often want to consider them when they shouldn't. This is called the *sunk cost fallacy*—continuing a behavior based on incurred costs that can't be retrieved.
    i. A business owner might buy a custom piece of equipment for a business venture. After starting the business, she discovers a related business would be more profitable. But this new venture wouldn't require this piece of equipment.
    ii. Because the equipment costs are gone regardless of what's done, it shouldn't be a factor in her decision. But she's likely to continue on her original plan because she doesn't want to "waste" the money.
e. As a result, economists are bigger fans of quitting than most. People who "refuse to quit" can get stuck in a bad project or job or marriage. Quitting may free you up to "win" at something achievable. There are always opportunity costs.