Economics is about operating in a globalized context

Deepti Garg | Gaurav Ojha | Jeeva B. | K. Sasikumar
Loveleena | Rakesh Ranjan | Shelat Harit Ketan | Tanu Singh

Contents

- Rationality
- Opportunity cost
- No free lunch

RATIONALITY

Rationality

- Homo Economicus – rational, narrow, self interested

- Consumer: Utility
- Producer: Profit

- Adam Smith and David Ricardo

- Least possible effort, maximum returns

Rational Choice Theory

- Rational behavior:
  - Goal-oriented
  - Evaluative
  - Consistent

- Assumptions:
  - Completeness (>, <, =)
  - Transitivity (x > y, y>z implies x>z)
  - Reflxivity (x ≥ x)
  - Perfect information

- Example: Pulses hoarding, co-ordinating clothes shopping during sales season, co-ordinating sales season around festivals

Drawbacks

- Homo reciprocans: Tesla Motors
- Altruism: The case of Aruna Roy
- Information asymmetry: which is the best dish in the restaurant?
- The psychology of choice
- Behavioral economics: for example, retail shopping as therapy

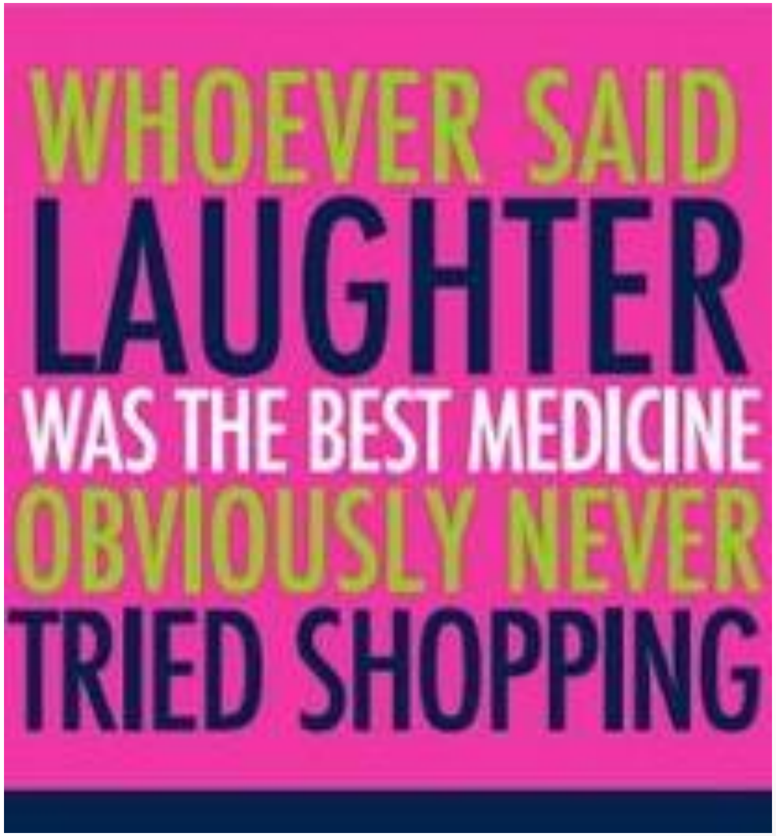
Homo reciprocans

Altruism

Information Asymmetry

"The "Special" tonight, as on other nights, will be whatever we have most of."

Behavioral economics - Retail Therapy



The psychology of choice

BOX 7.1 THE EFFECT OF FRAMING ON DECISIONS

Suppose that you are presented with the following question:

> Imagine you are a physician working in an Asian village, and 600 people have come down with a life-threatening disease. Two possible treatments exist. If you choose treatment A, you will save exactly 200 people. If you choose treatment B, there is a one-third chance that you will save all 600 people, and a two-thirds chance you will save no one. Which treatment do you choose, A or B?

Kahneman and Tversky found that the majority of respondents (72 percent) chose treatment A, which saves exactly 200 people. Now consider the following scenario:

> You are a physician working in an Asian village, and 600 people have come down with a life-threatening disease. Two possible treatments exist. If you choose treatment C, exactly 400 people will die. If you choose treatment D, there is a one-third
>
> chance that everyone will die. Which treatment do you choose, C or D?

In this case, they found that the majority of respondents (78percent) chose treatment D, which offers a one-third chance that no one will die. But if you compare the two questions carefully, you will notice that they are exactly the same! Treatments A and C are identical, and so are treatments B and D. The only thing that changes are the way the options are presented, or framed, to respondents.

According to Tversky and Kahneman people evaluate gains and losses differently. Thus while treatments A and C are quantitatively identical, treatment A is framed as a gain (i.e., you save 200 people) while treatment C is framed as a loss (i.e., 400 people die). It seems people are more likely to take risks when it comes to losses than gains. In other words, people prefer a "sure thing" when it comes to a potential gain but are willing to take a chance if it involves avoiding a loss.

Source: Amos Tversky and Daniel Kahneman, "The Framing of Decisions and the Psychology of Choice," *Science*

OPPORTUNITY COST

Opportunity Cost

- Arises of trade-off made
- Value of the best alternative forgone, where a choice needs to be made between several mutually exclusive alternatives, given limited resources
- Relationship between ‘scarcity’ & ‘choice’: use of scarce resource efficiently
- Cost: financial, time, pleasure etc.

Opportunity cost: production

Opportunity cost

Explicit cost

Implicit cost

Involve direct monetary payment by producers

- Tangible expenses
  - e.g. Wage, insurance, food ingredients

Measured in units of money, but are not paid for directly in money

- Opportunity cost of doing business / cost of capital etc.
- e.g. labor of owner who works for the company but does not draw salary

Profits

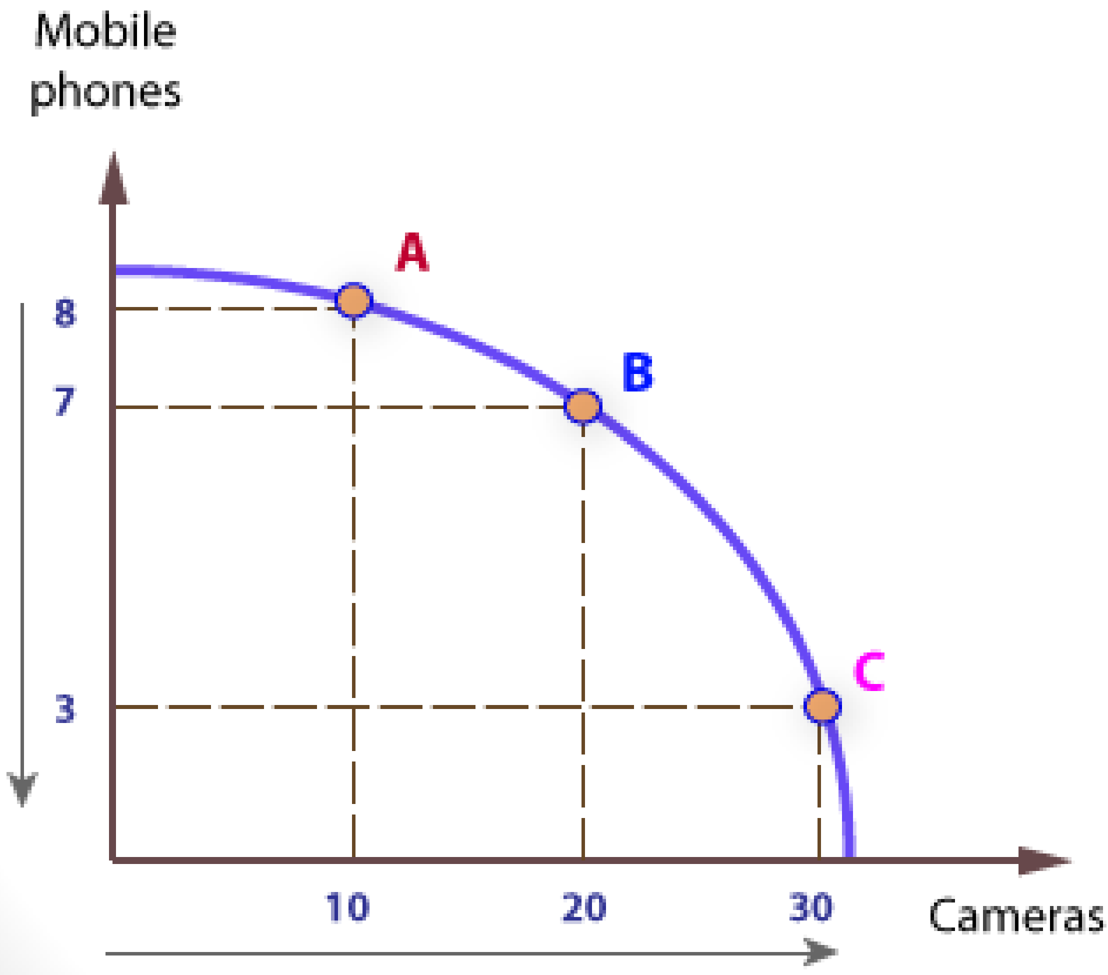
- Accounting Profit
  - Does not take into account implicit costs of doing business

Accounting Profit = Revenues – Explicit Costs

- Economic Profit
  - Considers "All Costs" = (Explicit Costs + Implicit Costs)

Economic Profit = Revenues – All Costs

Role of OC in production



Application of Opportunity Cost

- Consumer choice
- Production possibilities
- Cost of capital
- Time management career choices
- Analysis of comparative advantage

“There ain’t no such thing as a free lunch in this world.”

There's no such thing as a free lunch.

(Milton Friedman)

No Free Lunch: A Layman Approach

DEFINITION of 'Free Lunch‘

- A situation in which a good or service is received at no cost, with the true cost of the good or service ultimately borne by some party, which may even include the recipient
- A "free lunch" was often offered during the 1800s to bar patrons who ordered drinks as a way of bringing in more business, though in modern times the term is used to describe anything purportedly received for free
- From this, "free lunch" became an investment slang term referring to unlimited riskless profits

source: Investopedia

No Free Lunch

Phrase used to describe situations in which investors are not able to consistently make large profits without bearing the risk of a potential loss

E.G. a free breakfast offered by a hotel to entice consumers to stay the night is not free, as the hotel room is still being paid for

Free Lunch & Opportunity Cost

- It is impossible for a man to get something for nothing. Every choice you make has a next, best alternative that you *could* have chosen but didn't. That foregone opportunity is known as **opportunity cost**

The price you paid for doing whatever it is you did was the opportunity you can no longer enjoy

Free Lunch & Opportunity Cost

- Opportunity cost is all around you

- Knowledge is power. The more you know about a given area, such as investing in stocks, investing in bonds, or investing in real estate, the more options you have.

- The more options you have, the better the chances you can earn a decent rate of return on your money.

Free Lunch & Opportunity Cost

- Awareness of these types of costs is critical to the economic way of thinking. It helps us navigate a world where choices are hurled at us constantly.

- Using economics to help us think about our choices helps us understand that all of our choices are precious (they have meaning and imply sacrifice) and need to be made with intentionality (awareness of the foregone opportunities).

Free Lunch & Opportunity Cost

- If something is truly free, there is no need to count costs. In a fallen world, all of our choices bear costs
- Awareness of these costs will help us be intentional about how we donate our time, money and energy
- This new cost accounting can make our choices more fruitful and is one way we can become better stewards

THANK YOU