**W1 V3 Economic Costs**

0:10  
In this video, we're going to do a couple of definitions.

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I know students get caught up a lot in the definitions, so let's define them.

0:17  
And let me tell you what to pay attention to and what not to pay attention to.

0:21  
And we're going to talk a little bit more.

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I know I've been talking about economists versus accountants, so let's delve into that a little bit deeper in this video.

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And then something that's going to come up much later.

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But I do want to bring it up here so it has time to kind of settle down and be at the back of your head.

0:37  
One of the things we're going to talk about later is 0 profits and we're going to talk about how phones in equilibrium make 0 profits and students kind of find that really unintuitive.

0:47  
So let's talk about that now since we're doing opportunity cost because it is going to be tried tied to that and then we'll bring it back up in Module 8 when we're doing that.

0:57  
OK.

0:57  
So one of the differences between accountants and economists is what costs we keep track of and what costs they don't keep track of, right.

1:08  
So what accountants do keep track of what we call explicit costs, right, Stuff that you can get a receipt for, it's something that you're actually paying for and you can get a receipt for.

1:18  
Accountants will have that.

1:19  
Economists also keep track of that.

1:21  
And we call that explicit costs.

1:23  
And typically that's like a price that we associate with them, But we also keep track of what we call implicit costs, right?

1:30  
Costs are the value of resources that we think of as important when making choices.

1:37  
But you don't necessarily get a receipt for us.

1:39  
In the previous video, we've kind of talked about how to use time to think about that.

1:43  
OK.

1:45  
Opportunity cost, and you may have seen this in the textbook or outside, is sometimes framed as explicit cost plus implicit cost.

1:52  
And the reason they do that is they want to remind you, please don't forget about implicit cost because that's what's different from what you're used to thinking about.

2:00  
And so they kind of frame it this way.

2:02  
Now a lot of students at this point take it literally to say if I need to calculate opportunity cost, I'm going to 1st need to calculate explicit cost, then implicit cost.

2:11  
If you do that, there's a really high probability that you're going to make a mistake.

2:15  
Because, as I showed you in the previous videos, sometimes explicit costs are there, sometimes they're not because they cancel out, Sometimes implicit costs are there, sometimes they're not because they cancel out.

2:25  
OK, And if you're not paying attention, you're going to make mistakes.

2:29  
So do not use explicit plus implicit as a starting.

2:34  
Use it as a way to take a step back after you have calculated opportunity cost.

2:40  
So first start off with opportunity cost, then break it down and say, OK, what of this would an accountant have noticed and kept track of?

2:48  
And what of portion of opportunity cost is something that we have noticed and we have paid attention to, but we don't have a receipt for.

2:56  
OK.

2:57  
So that's the way I want you to use this equation, implicit plus explicit.

3:01  
But once we have the opportunity cost, then we can think about profits, right?

3:04  
Profits in general is just revenue minus costs.

3:06  
So we're used to that.

3:08  
But economic profits for economists is revenue minus opportunity cost, right?

3:14  
Because we want to think about all relevant costs, accounting profits, they just focus on explicit costs.

3:20  
So there's going to be revenue minus explicit costs or accounting costs.

3:26  
So there's going to be a difference between economists and accountants, and it's all going to come back down to this implicit costs.

3:32  
So please focus on calculating opportunity costs the right way.

3:35  
And then you're going to be able to focus on what portion of these costs the accountant would not catch.

3:43  
Let me give you another example.

3:44  
Right.

3:45  
So explicit cost, implicit cost.

3:48  
And there's another kind of sneaky cost in here that I want you to pay attention to.

3:51  
And you've done this in terms of the decisions that you make.

3:54  
Alright, so suppose there's this really fancy club, just open up $150.00 of an entry fee, right?

4:00  
And once you enter, they say drinks are free.

4:03  
Right?

4:03  
Now it's 1:00 AM you're looking at your clock and you have a midterm tomorrow, right?

4:09  
And then your friend says, you start to make noises.

4:11  
You're like, OK, I'm going to go home.

4:12  
But your friend turns around and says, no, you've paid $150.00 to enter.

4:15  
You should have at least another drink before going at this point, what would you do?

4:20  
Right.

4:20  
And this is typically framed as, oh, you've paid a lot of money, Let's get your money's worth.

4:26  
OK, what an economist would say at this point would be to say if you leave right now, are you going to get any of this $150.00 back, right?

4:38  
The answer is no.

4:39  
Then the economist would say it is not a relevant cost for your decision making because it is what we call a sunk cost.

4:47  
If you cannot get any resources out of something and reallocate it to something else, it doesn't matter.

4:55  
It's gone.

4:56  
Right.

4:57  
So this is kind of the economist's way of saying don't cry over spilt milk.

4:59  
It's done.

5:00  
It's gone.

5:01  
There's nothing you can do to get it back.

5:03  
So it is ignored.

5:04  
And we give it a fancy term that we call sunk cost.

5:08  
Right.

5:09  
These are costs that have already been spent.

5:11  
Fine.

5:12  
Sometimes they've spent, but you can get them back.

5:14  
If you cannot get them back, no matter what you do, right, you go to the bouncer and you say, please, I didn't drink enough.

5:21  
I want some money back.

5:22  
And they said, no, sorry, you paid it.

5:24  
Then it is sunk.

5:25  
It's gone.

5:25  
And they should not affect your choices.

5:28  
Why?

5:29  
Because if you can't reallocate it away, it has no alternative use.

5:33  
No alternative use means no opportunity cost of that.

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Right now it seems simple for an economist to say it's really hard for us to do in reality.

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So that's why we call this a some cost fallacy.

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And a lot of us are guilty of making decisions based on the some cost fallacy.

5:48  
But in economics, we're just going to say sunk gone.

5:52  
We don't care about it because if it doesn't have a next best alternative use or any alternative use not relevant for us, right?

6:00  
All we care about is allocation decisions cannot be reallocated.

6:04  
Gone.

6:04  
So some cost is another cost you need to pay attention to apart from explicit and implicit.

6:12  
OK, now last thing we want to talk about here is this idea of 0 economic profits.

6:16  
Now saying something A company makes 0 profits.

6:18  
Sounds ridiculous, right?

6:19  
Because you look around, you look at, you know, company reports and they're always making a profit and that's fine if they're making accounting profits, right?

6:28  
An economist would say if you're truly accounting for profits, you want to be thinking about economic profits, and economic profits should be opportunity cost.

6:39  
And so there will be explicit costs, stuff that the people are actually paying for it.

6:48  
But there's also implicit costs.

6:51  
And implicit costs here would be the next best use of some resources that are not valued in the explicit cost.

6:58  
For example, the CEO's time, right?

7:01  
Steve Jobs used to pay himself $1.00.

7:03  
So if you're looking at Apple profits just by putting in $1.00 for Steve Jobs, you think, wow, Apple is extremely profitable.

7:10  
But if you're truly valuing Steve Jobs is time at his next best alternative use, you may find Apple profits substantially lower, right?

7:18  
And in fact, if things are working well and we're going to see this in Module 8, we should expect zero economic profits.

7:26  
OK, it means that what a firm or a person or an individual is making is exactly equal to their opportunity cost.

7:34  
You're doing as best as you can relative to your next best alternative.

7:41  
Keep that in mind when we talk about 0 profits moving later, because that sometimes can be confusing.

7:46  
But we'll revisit it later.

7:49  
OK, so please pay attention to the types of costs you have.

7:53  
Explicit, implicit right.

7:56  
Use those to back them out after you've calculated opportunity costs.

7:59  
And if you notice some costs, irrelevant, we ignore it, OK?

8:03  
Any cost that we talk about now, going forward, end of time, always opportunity cost, right?

8:09  
And please do not use the explicit plus implicit formula.

8:12  
Use the concept, use the structure.

8:15  
Thinking that we've explained in the previous video, you can't go wrong.