Opportunity cost

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1. OPPORTUNITY COST

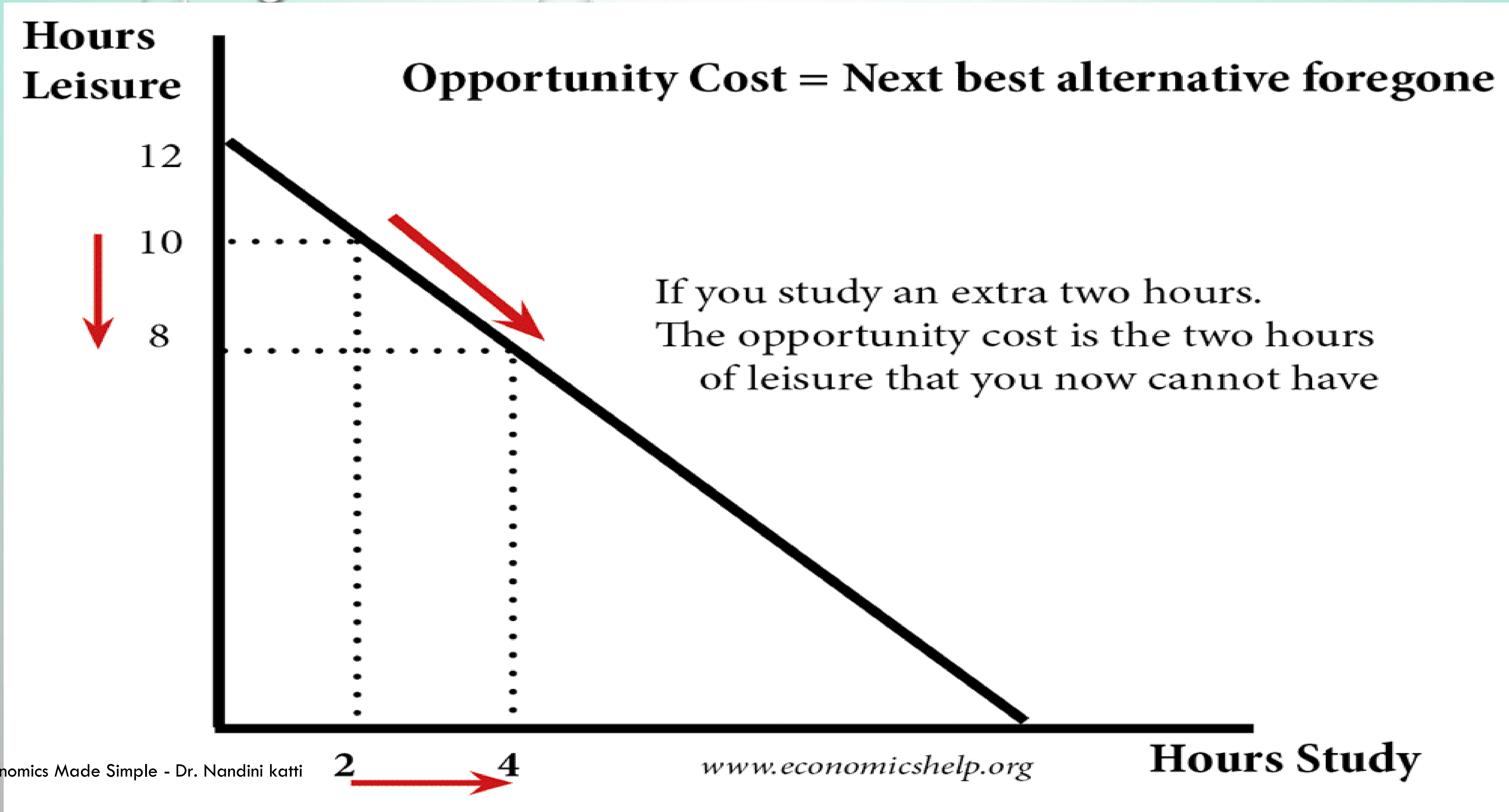
- **This concept of opportunity cost is very important in economic analysis to understand how choices are made by households, firms and governments**
- **The opportunity cost of a chosen activity or commodity is the value of the next best alternative that is foregone**

The choice and sacrifice needs to be made because;

(a) resources are scarce; and

(b) resources have alternative uses

- **If we spend that Rs. 20 on a textbook, the opportunity cost is the restaurant meal we cannot afford to pay.**
- **If you decide to spend two hours studying on a Friday night. The opportunity cost is that you cannot have those two hours for leisure.**


Hours
Leisure
Opportunity Cost = Next best alternative foregone
12
10
8
If you study an extra two hours.
The opportunity cost is the two hours
of leisure that you now cannot have
2
4
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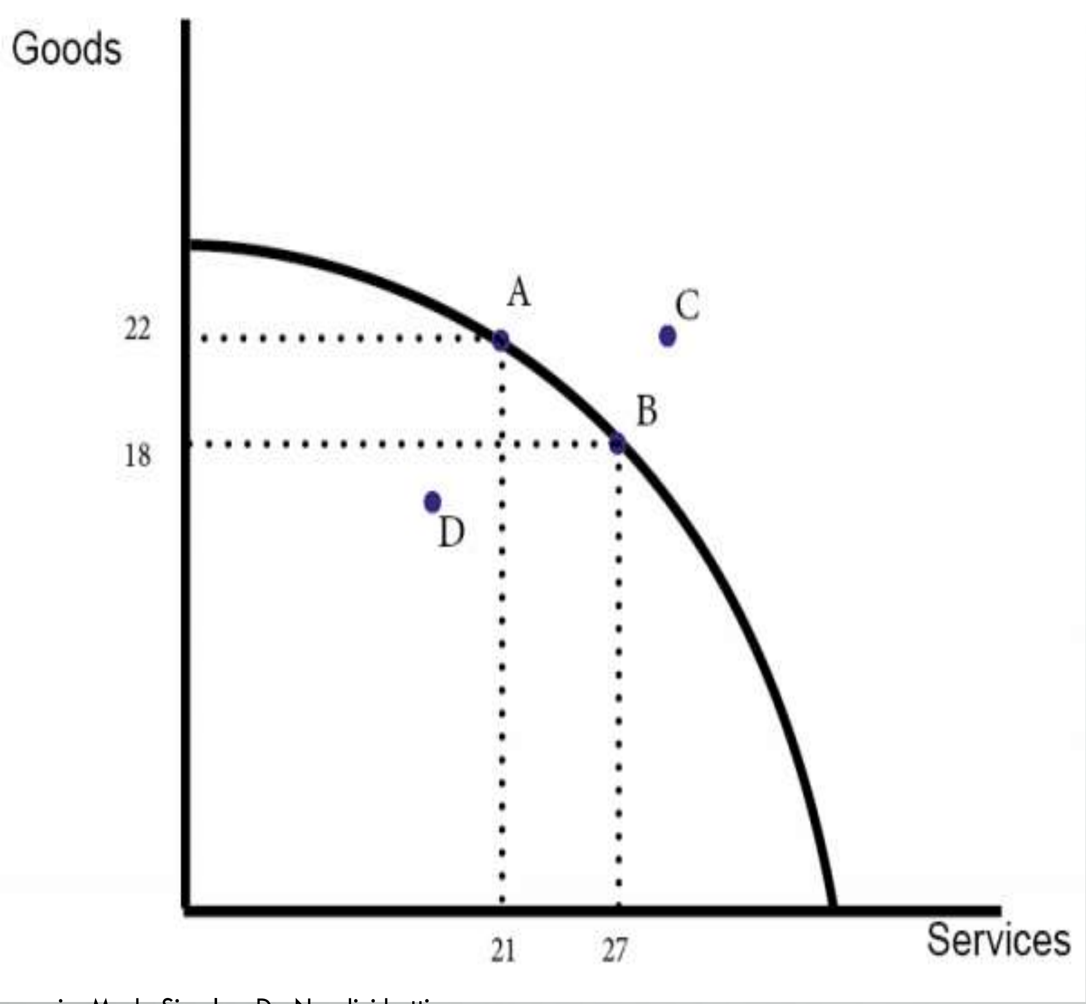
Hours Study

Importance of opportunity cost

- The fundamental problem of economics is the issue of scarcity.
- Therefore we are concerned with the optimal use and distribution of these scarce resources.
- Wherever there is scarcity we are forced to make choices.
- Therefore, many choices involve an opportunity cost – having to make choices between the two.

Production possibility frontier and opportunity cost

- A production possibility frontier shows the maximum combination of factors that can be produced.



- Moving from Point A to B will lead to an increase in services (21-27). But, the opportunity cost is that output of goods falls from 22 to 18.
- Therefore, the opportunity cost of increasing consumption of services is the 4 goods foregone.
- At point D, the economy is inefficient. We can increase both goods and services without any opportunity cost.
- C is currently impossible.

Examples of opportunity cost

1. **The cost of war.** If the government spends RS.870bn on a war, it is Rs. 870bn they cannot spend on education, health care or cutting taxes / reducing the budget deficit.

2. **Spending on new roads**. If the government build a new road, then that money can’t be used for alternative spending plans, such as education and healthcare.

3. **Tax cuts**. If the government offers an income tax cut, the opportunity cost is that government revenue cannot be used to finance some aspect of government spending.

Examples of opportunity cost

4. **Time.** If you have 12 hours at your disposal during the day, you could spend these hours in work or leisure. The opportunity cost of spending all day watching TV is that you are not able to do any study during the day.
5. **Enter the workforce at 16.** If you enter the workforce at 16 without qualifications you start earning money straight away. But the opportunity cost is that you lose out on the potential of getting better qualifications and possibly a higher salary in the long-run.
6. **Investing today for consumption tomorrow**: The opportunity cost of an economy investing resources in capital goods is the production of consumer goods given up for today