

## Opportunity Cost

BY ERIC NIELSEN

There is an old saying, “You can’t have your cake and eat it too.” Although this bit of folk wisdom may seem corny, it carries with it significant economic wisdom. It gets at the heart of one of the most important concepts in economics: opportunity cost. The opportunity cost of something is simply what you must give up in order to get it.

Resources are always limited, so not all wants can be satisfied. When you take a course of action, you use resources that cannot be applied to other projects. The opportunity cost is the value of those foregone opportunities. For example, if you decide to spend your money on a new bicycle, you cannot also spend it on a new computer. Or if you spend an hour watching television, you cannot also spend that time reading a book.

Opportunity cost is in many ways the most fundamental idea in economics. Economics at its core is the study of how decisions are made about the allocation of finite resources in the real world. If resources were not limited, there would be no reason to forego any desired activity and all projects could be undertaken. Every action has an opportunity cost, so it is important to try to understand the full extent of these costs.

Before the emergence of money, people traded goods directly, which made opportunity-cost relationships more obvious. One of the main functions of money, then, is to assign a unit of account to the relative costs of various items. Rather than having countless hard-to-fulfill barter relationships — such as “as one car costs 1,500 pizzas” — you need only have their prices in dollars. The dollar price of various items reflects their opportunity costs.

To make an economic decision, you must fully consider the opportunity costs associated with various options. For example, say you are confronted with the choice of flying or driving to visit a friend in Chicago. A plane ticket costs \$300, while gas for your car will only be \$125. Given those figures, it’s more economical to drive, right? Actually, the answer is not so clear. For instance, if it takes two days to drive to Chicago and back but only four hours to fly, a person earning a reasonably good salary

would be better off working the extra day and a half, and then flying. For a student or someone else with little earning power, it still might be cheaper to spend the extra time and drive. So opportunity cost decisions involve many more factors than simply the dollar costs associated with various alternatives.

Opportunity cost also plays an important role in what economists call the labor-leisure decision. Possibly the most basic decision you can make is how to divide your time between work and play. All else being equal, most people prefer leisure to labor. At the same time, the greater wealth which comes from working allows us to consume things we like, and gives us

greater freedom as to how we spend our leisure hours. You must take into account the competing desires to have some money to spend versus the pleasure of relaxation; the opportunity cost of taking a day off is the amount that you could have earned if you had worked. As another old saying goes, “Time is money.”

Governments must also consider the opportunity costs of their actions. For instance, it would seem that a natural way to increase revenues would be to raise marginal

tax rates — that is, raise the rate at which each additional dollar of personal income is taxed. Although it would appear that a higher tax rate on a given income stream would yield proportionally higher total tax revenue for the government, that is not necessarily the case. By raising marginal rates, the government has altered the labor-leisure calculation; it is now cheaper for a worker to forego an extra unit of labor in favor of leisure. The tax increase, then, likely will have the effect of reducing how much people work — which will tend to dampen or, in extreme cases, possibly even reverse the expected effect of the rate hike.

In short, many choices have consequences that are not immediately obvious. But to fully evaluate any decision — whether it is made by an individual or by the government — people must consider both “the seen and the unseen,” as the 19th century French economist Frederic Bastiat put it. Opportunity costs are often unseen, yet they remain real and important.

**RF**



ILLUSTRATION BY TIMOTHY COOK