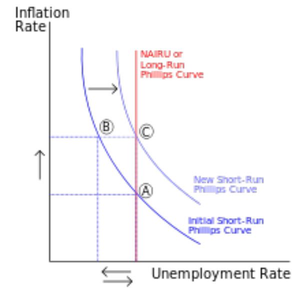
Opportunity cost

In microeconomic theory, the **opportunity cost of a choice** is the value (not a benefit) of the choice of a best alternative lost while making a decision. A choice needs to be made between several mutually exclusive alternatives. Assuming the best choice is made, it is the "cost" incurred by not enjoying the *benefit* that would have been had by taking the second best available choice.[1] The *New Oxford American Dictionary* defines it as "the loss of potential gain from other alternatives when one alternative is chosen." Opportunity cost is a key concept in economics, and has been described as expressing "the basic relationship between scarcity and choice."[2] The notion of opportunity cost plays a crucial part in attempts to ensure that scarce resources are used efficiently.[3] Thus, opportunity costs are not restricted to monetary or financial costs: the real cost of output forgone, lost time, pleasure or any other benefit that provides utility should also be considered an opportunity cost.

Economics



Phillips curve graph, illustrating an economic principle

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History

The term was coined in 1914 by Austrian economist Friedrich von Wieser in his book *Theorie der gesellschaftlichen Wirtschaft*.[4] The idea had been anticipated by previous writers including Benjamin Franklin and Frédéric Bastiat. Franklin coined the phrase "Time is Money", and spelt out the associated opportunity cost reasoning in his “Advice to a Young Tradesman” (1746): “Remember that Time is Money. He that can earn Ten Shillings a Day by his Labour, and goes abroad, or sits idle one half of that Day, tho’ he spends but Sixpence during his Diversion or Idleness, ought not to reckon That the only Expence; he has really spent or rather thrown away Five Shillings besides.”

Bastiat's 1848 essay "What Is Seen and What Is Not Seen" used opportunity cost reasoning in his critique of the broken window fallacy, and of what he saw as spurious arguments for public expenditure.

Opportunity costs in production

Explicit costs

Explicit costs are opportunity costs that involve direct monetary payment by producers. The explicit opportunity cost of the factors of production not already owned by a producer is the price that the producer has to pay for them. For instance, if a firm spends $100 on electrical power consumed, its explicit opportunity cost is $100.[5] This cash expenditure represents a lost opportunity to purchase something else with the $100.

Implicit costs

Implicit costs (also called implied, imputed or notional costs) are the opportunity costs that are not reflected in cash outflow but implied by the failure of the firm to allocate its existing (owned) resources, or factors of production to the best alternative use. For example: a manufacturer has previously purchased 1000 tons of steel and the machinery to produce a widget. The implicit part of the opportunity cost of producing the widget is the revenue lost by not selling the steel and not renting out the machinery instead of using them for production.

One example of opportunity cost is in the evaluation of "foreign" (to the USA) buyers and their allocation of cash assets in real estate or other types of investment vehicles. With the recent downturn (circa June/July 2015) of the Chinese stock market, more and more Chinese investors from Hong Kong and Taiwan are turning to the United States as an alternative vessel for their investment dollars; the opportunity cost of leaving their money in the Chinese stock market or Chinese real estate market is too high relative to yields available in the USA real estate market

Evaluation

Note that opportunity cost is not the *sum* of the available alternatives when those alternatives are, in turn, mutually exclusive to each other. It is the *next best* alternative given up selecting the best option. The opportunity cost of a city's decision to build the hospital on its vacant land is the loss of the land for a sporting center, or the inability to use the land for a parking lot, or the money the city could have made by selling the land. Use for any one of those purposes precludes all the others.

If someone loses the opportunity to earn money, that is part of the opportunity cost. If someone chooses to spend money, that money could be used to purchase other goods and services so the spent money is part of the opportunity cost as well. Add the value of the next best alternatives and you have the total opportunity cost. If you miss work to go to a concert, your opportunity cost is the money you would have earned if you went to work plus the cost of the concert.[6]

Example

Q

Suppose you have a free ticket to a concert by *Band X*. The ticket has no resale value. On the night of the concert your next-best alternative entertainment is a performance by *Band Y* for which the tickets cost $40. You like *Band Y* and would usually be willing to pay $50 for a ticket to see them. What is the *opportunity cost* of using your free ticket and seeing *Band X* instead of *Band Y*?

A

The benefit you forgo (that is, the value to you) is $10: the $50 benefit of seeing *Band Y* less the ticket cost of $40.[7]

See also

- Budget constraint
- Economic value added
- Fear of missing out
- Opportunity cost of capital
- Parable of the broken window
- Production-possibility frontier
- There Ain't No Such Thing As A Free Lunch
- Time management
- Trade-off
- Best alternative to a negotiated agreement

References

1. ↑ "Opportunity Cost". *Investopedia*. Retrieved 2010-09-18.
2. ↑ James M. Buchanan (2008). "Opportunity cost". *The New Palgrave Dictionary of Economics Online* (Second ed.). Retrieved 2010-09-18.
3. ↑ "Opportunity Cost". *Economics A-Z*. The Economist. Retrieved 2010-09-18.
4. ↑ Friedrich von Wieser (1927). A. Ford Hinrichs (translator), ed. *Social Economics* (PDF). New York: Adelphi. Retrieved 2011-10-07.
   • Friedrich von Wieser (November 1914). *Theorie der gesellschaftlichen Wirtschaft* [*Theory of Social Economics*] (in German). Original publication.
5. ↑ Explicit vs. Implicit Cost
6. ↑ "AP Economics Review: Cost, Revenue, and Profit". *ReviewEcon.com*. Retrieved 2016-10-14.
7. ↑ Gittins, Ross (19 April 2014). "At the coal face economists are struggling to measure up". *The Sydney Morning Herald*. Retrieved 23 April 2014.

Further readings

- Henderson, David R. (2008). "Opportunity Cost". *Concise Encyclopedia of Economics* (2nd ed.). Indianapolis: Library of Economics and Liberty. ISBN 978-0865976658. OCLC 237794267.
- Roberts, Russell (February 5, 2007). "Getting the Most Out of Life: The Concept of Opportunity Cost". Library of Economics and Liberty.

External links

- The Opportunity Cost of Economics Education by Robert H. Frank
- Opportunity Cost Example & Analysis

Wikiquote has quotations related to: ***Opportunity cost***

Microeconomics

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