

Opportunity cost: definition and examples

[Government](#)



Opportunity cost is the value of the next best alternative forgone when a decision is made. It encapsulates the relationship between scarcity and choice, two important pillars of economic thought, since scarcity causes any choice to have an opportunity cost. (Buchanan, 2017) It is imperative to note that if there are multiple mutually exclusive options, only the highest value option is counted and that sunk costs, costs incurred in the past that cannot be recovered, are kept out. Opportunity costs are always expressed as the value of the option foregone and not the option itself. For more intangible costs like time lost or pleasure derived, we may use a shadow price, which is based on the WTP (willingness to pay) principle – the most accurate measure of value of a good is the amount people are willing to give up to get it.

During his time as US president, Dwight Eisenhower identified the true cost of defense, saying how every gun made, warship launched and rocket fired signified a theft from the hungry, the unclothed and the unsheltered. He stated that the US was not just spending its money alone on arms, but also the force of its labourers, the genius of its scientists and the aspirations of its children. (Ambrose, 1984) Eisenhower was able to not only identify the correct opportunity cost, but also classify it into explicit (cost of purchasing raw materials for arms manufacture) and implicit (harnessing the efforts of scientists and labourers and shaping the futures of children). The explicit part of opportunity costs includes direct monetary payments, while the implicit part does not show up in cash outflows but is implied by the choice.

Opportunity cost ought to be, and is, a fundamental part of decision making and forms the backbone of the argument about the benefits of trade.

Assuming rationality amongst economic agents, any decision made should

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be such that the value derived from that exceed the opportunity cost. The historical cost or any other costs should not be factored into this decision-making process. Apple learnt this lesson the harsh way. In 1988, they sold their Macintosh factoring in the historical cost (purchase cost) of \$38 per memory chip, while the market price had fallen to \$23, which was the correct economic cost to consider. Apple's profits plummeted that year and they were left with millions of unsold memory chips. (Katz and Rosen, 1998)