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Opportunity Cost and Markets



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- In well functioning markets, when all costs are included, price equals opportunity cost.



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Opportunity Cost Outside Markets

- The concept of opportunity cost is particularly crucial when you are analyzing transactions that take place outside markets.
- How do you measure the value of a road or a park? Of a health or safety regulation?
- Even the allocation of student time can be explained using opportunity cost.



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Example

- The notion of opportunity cost explains why students watch more TV the week after exams than the week before exams.
- Watching TV right before an exam has a high opportunity cost, for the alternative use of time (studying) has high value in improving grade performance and getting a good job.
- After exams, time has a lower opportunity cost.



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Example

- Take the case of a proposal to drill for oil off the California coast. A storm of complaints is heard. A defender of the program states, “We need that oil to protect us from insecure foreign sources who are holding us hostage. We have plenty of seawater to go around. This is just good economics for the nation.”
- In fact, it might be poor economics because of the opportunity cost. If drilling leads to oil spills that spoil the beaches, it might reduce the recreational value of the ocean.
- That opportunity cost might not be easily measured, but it is every bit as real as the value of oil under the waters.



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Economic costs include, in addition to explicit money outlays, those opportunity costs incurred because resources can be used in alternative ways.



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Happy Learning

