

ECO 2013 – Principles of Economics (Macro)

Ch. 2 Economic Decision-Making & Opportunity Cost

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2. Economic Decision Making & Opportunity Cost

Imagine standing in front of your closet, contemplating a stack of 20's. Should you buy those trendy esnikels or invest in a new graphing calculator for math class? This everyday scenario is economic decision making in action. Every choice we make, from spending money to using time, involves weighing costs and benefits. Let's explore the world of economic decision making and the crucial concept of opportunity cost.

OPPORTUNITY COST

DEFINITION

Opportunity cost is the cost of giving up one opportunity in order to take another one. The 'next best alternative' that must be given up comes with a cost.

A modern definition is:

"Current day economists generally define opportunity Cost as the value of the resource in its next best use."

EXAMPLE

College or Gap Year?

If you choose to take the job, you're giving up an amazing and educational travel experience. If you choose to take a gap year, you're giving up a lot of money. Either way, you're giving up one thing to achieve the other.

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Understanding Economic Decision Making

Economic decision making is the process of choosing the best option among limited resources to satisfy our unlimited wants and needs. It applies to all aspects of life where we face choices.

NEEDS VS WANTS

NEEDS

Basic needs refer to the requirements that are essential for an individual to survive and function optimally. Without satisfying these needs, an individual's health, safety, or well-being may be compromised. **Growth needs** are the things that are essential to achieve goals, such as self-optimization and mental health.

WANTS

Wants are desires or aspirations that individuals seek to attain or possess, often driven by personal preferences or societal influences. Unlike needs, wants are not crucial for achieving our goals but add comfort, pleasure, or luxury to one's life. They are often influenced by cultural, social, or individual tastes and can change over time.

The PACED Decision-Making Model

To make sound economic decisions, economists often use the PACED model:

1. Define the Problem
2. List the alternatives
3. Select the Criteria
4. Evaluate the alternatives
5. Make a Decision

This approach helps us navigate complex choices
And make good decisions.



The Role of Incentives

Incentives play a crucial role in economic decision making. These factors motivate or influence our choices. Positive incentives, like discounts or rewards, encourage certain behaviors. Negative incentives, such as fines or penalties, discourage others. Understanding incentives helps us predict and explain economic behaviors.

Incentives: The Key to Economics

- ▣ **All of economics** rests on this principle....
- ▣ **Incentive:** the hope for a reward or the fear of a punishment.
- ▣ There are **TWO** types of incentives...
- ▣ **Positive** incentives...
- ▣ And **negative** incentives.
- ▣ A positive incentive is a **REWARD**...
- ▣ And a negative incentive is a **PUNISHMENT**.



Calculating Opportunity Cost

Imagine you have two hours of free time. You could either watch a movie or study for an upcoming test. If you choose to watch the movie, the opportunity cost is the potential improvement in your test score that you forgo. It's not just about time- it's about the value of what you're giving up.

Explicit vs. Implicit Costs

When considering opportunity costs, we need to think about both explicit and implicit costs:

- Explicit costs are direct monetary expenses.
- Implicit costs are the hidden or indirect costs, some monetary-related, some non-monetary related.
- These implicit *nonmonetary costs* are most often related to time during which you could have engaged in other activities.

Explicit cost

A transaction that has measurable cost to a firm

Purchase of new assets

Hiring of workers

Purchase of raw materials

Implicit cost

A decision which leads to lower income, but is not recorded on balance sheet

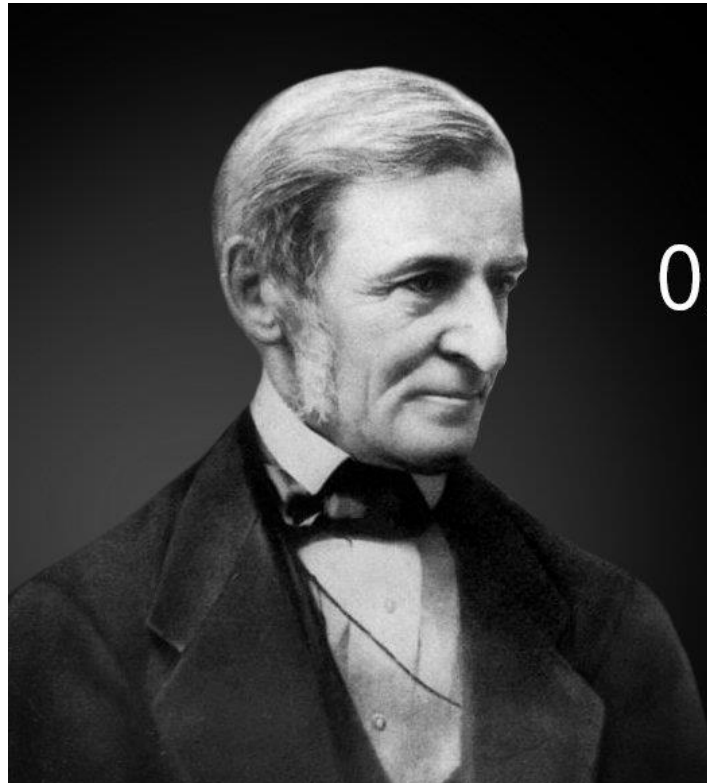
E.g. giving workers a day off
– will lead to a drop in sales and income.

Relevance to Your Life

Understanding economic decision making and opportunity cost is crucial for making informed choices in your daily life. Whether you're deciding how to spend your weekend, which college to attend, or how to budget your allowance, these concepts come into play.

By applying the PACED model and considering opportunity costs, you can:

1. Make more rational decisions
2. Better understand the true cost of your choices
3. Allocate your resources (time, money, energy) more effectively
4. Improve your long-term financial planning



Once you make a **decision**,
the universe conspires
to make it **happen**.

– *Ralph Waldo Emerson*

FIND A REFRESHING DRINK,

AND STUDY THE FOLLOWING TEXT...



**But first hear the
Roberto & Me story**

Real-World Example: Choosing a Summer Job

Let's apply these concepts to a real-world scenario. Imagine you're deciding between two summer job offers:

1. Lifeguard at a local pool: \$10/hour, 30 hours/week
2. Intern at a tech startup: \$8/hour, 40 hours/ week

At first glance, the lifeguard job might seem more appealing due to the higher hourly rate. However, let's break it down using our economic decision-making tools:

1. Calculate total earnings:

- Lifeguard: $\$10 \times 30 \times 12 \text{ weeks} = \$3,600$
- Intern: $\$8 \times 40 \times 12 \text{ weeks} = \$3,840$

2. Consider opportunity costs:

- Choosing the lifeguard job means forgoing \$240 in total earnings
- The intern position offers valuable career experience and networking opportunities

3. Evaluate implicit costs:

- Lifeguard job may offer more flexible hours for summer activities
- Intern position may require a longer commute or more formal attire

By considering all these factors, you can make a more informed decision that aligns with your long-term goals and values.

Applying Economic Decision Making

To reinforce your understanding, try this exercise:

1. Identify a significant decision you need to make soon (e.g., choosing classes for next semester, deciding on an extracurricular activity)
2. List all possible alternatives
3. Establish criteria for evaluating these options
4. Evaluate each alternative based on your criteria
5. Make your decision and identify the opportunity cost

By practicing this process, you'll develop stronger decision-making skills that will serve you well in all areas of life.

Economic decision making and understanding opportunity cost are essential skills that extend far beyond the classroom. By mastering these concepts, you'll be better equipped to navigate the complex choices you'll face throughout your life. Every decision has a cost-the key is to make choices that align with your values and long-term goals. Mastering these concepts, you'll be better equipped to navigate the complex choices you'll face throughout your life.