



Chapter 1: What is Economics? Section 2

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ECONOMICS

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Objectives

1. **Explain** why every decision involves trade-offs.
2. **Summarize** the concept of opportunity cost.
3. **Describe** how people make decisions by thinking at the margin.



Key Terms

- **trade-off**: the alternatives that we give up when we choose one course of action over another
- **“guns or butter”**: a phrase expressing the idea that a country that decides to produce more military goods (“guns”) has fewer resources to produce consumer goods (“butter”) and vice versa
- **opportunity cost**: the most desirable alternative given up as the result of a decision



Key Terms, cont.

- **thinking at the margin:** the process of deciding how much more or less to do
- **cost/benefit analysis:** a decision-making process in which you compare what you will sacrifice and gain by a specific action
- **marginal cost:** the extra cost of adding a unit
- **marginal benefit:** the extra benefit of adding a unit



- How does opportunity cost affect decision making?
 - Every time we choose to do something, like sleep in late, we are giving up the opportunity to do something less, like study an extra hour for a big test.
 - When we make decisions about how to spend our scarce resources, like money or time, we are giving up the chance to spend that money or time on something else.



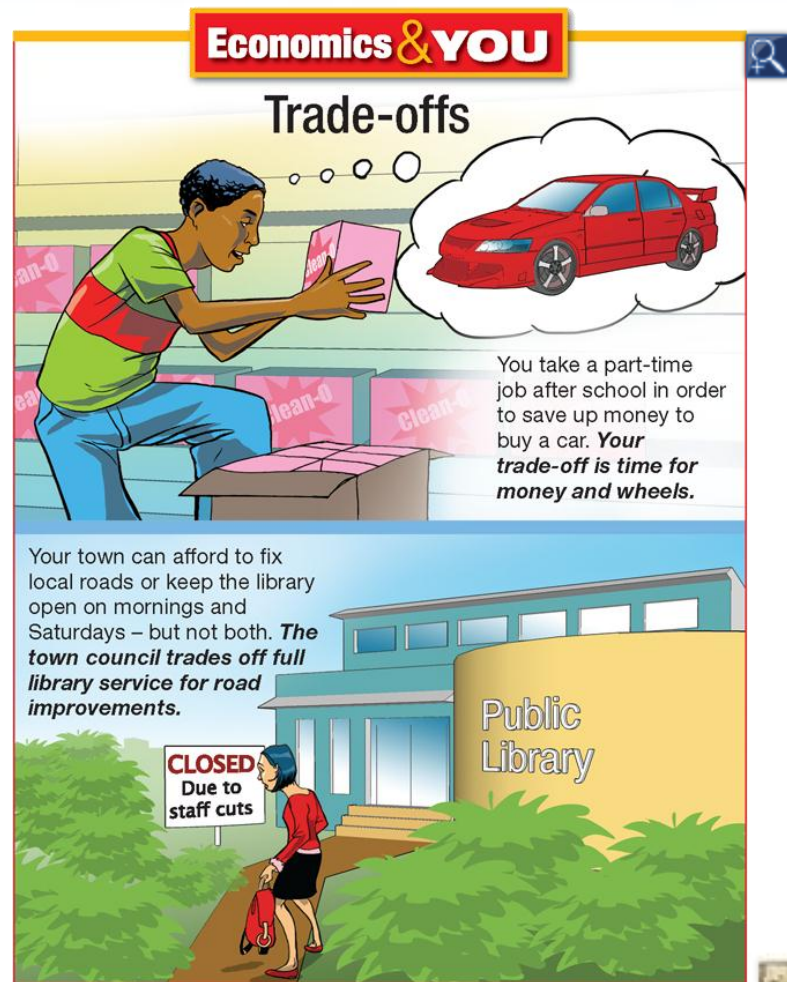
Trade-offs

- All individuals, businesses, and large groups of people make decisions that involve trade-offs.
- Trade-offs involve things that can be easily measured such as money, property, and time or things that cannot be easily measured, like enjoyment or job satisfaction.



Businesses and Governments

- Businesses make trade-offs when they decide how to use their factors of production.
 - A farmer who uses his or her land to plant broccoli, for example, cannot use that same land to plant squash.
- Governments also make trade-offs when they decide to spend their money on military needs instead of domestic ones, and vice versa.



Opportunity Costs

- In most trade-offs, one of the rejected alternatives is more desirable than the rest.
- The most desirable alternative somebody gives up as a result of a decision is the opportunity cost.




Decision-Making Grids

- Checkpoint: Why does every choice involve an opportunity cost?
 - We always face an opportunity cost. When we select one alternative, we must sacrifice another.
- Using a decision-making grid can help you decide if you are willing to accept the opportunity cost of a choice you are about to make.

KAREN'S DECISION-MAKING GRID

	Alternatives	
	Sleep late	Wake up early to study
Benefits	<ul style="list-style-type: none">• Enjoy more sleep• Have more energy during the day	<ul style="list-style-type: none">• Better grade on test• Teacher and parental approval• Personal satisfaction
Benefits forgone	<ul style="list-style-type: none">• Better grade on test• Teacher and parental approval• Personal satisfaction	<ul style="list-style-type: none">• Enjoy more sleep• Have more energy during the day
Opportunity cost	Extra study time	Extra sleep time



Thinking on the Margin

- When you decide how much more or less to do, you are thinking on the margin.
 - Deciding by thinking on the margin involves comparing the opportunity costs and benefits.
 - This decision-making process is called a cost/benefit analysis.




Marginal Costs and Benefits

- To make good decisions on the margin, you must weigh marginal costs against marginal benefits.
 - The marginal cost is the extra cost of adding one unit such as sleeping an extra hour or building one extra house.
 - The marginal benefit is the extra benefit of adding the same unit.
- Once the marginal costs outweigh the marginal benefit, no more units can be added.



Cost/Benefit Analysis

- The cost/benefit analysis below shows the opportunity costs and benefits of extra hours of sleep against extra hours of study time.
 - What is the opportunity cost of one extra hour of sleep? What is the benefit?



Options	Benefit	Opportunity Cost
1st hour of extra study time	Grade of C on test	One hour of sleep
2nd hour of extra study time	Grade of B on test	2 hours of sleep
3rd hour of extra study time	Grade of B+ on test	3 hours of sleep



Decision-Making on the Margin

- Like opportunity cost, thinking at the margin applies not just to individuals, but to businesses and governments as well.
 - Employers think at the margin when they decide how many workers to hire.
 - Legislators think at the margin when they decide how much to increase government spending on a particular project.



Review

- Now that you have learned how opportunity costs affect decision making, go back and answer the Chapter Essential Question.
 - How can we make the best economic choices?

