

Understanding Opportunity Costs and the Economist's View: A Response to "The Economist's Fallacy"

Brad R. Watts

Western Michigan University

Of course, the concept of opportunity costs has generally remained in the domain of economists and its understanding and acceptance are not universal in other fields, including evaluation. Indeed, in the last issue of the *Journal of Multidisciplinary Evaluation* (JMDE), Michael Scriven spoke out against the use of opportunity costs in evaluation. Unfortunately, what may appear to Scriven to be flaws of logic and utility in the economists' concept of cost are the result of some common misunderstandings about what a "cost" is—at least in terms of how economists use the term. However, I believe that the points raised by Scriven can be either corrected or clarified in a way that will illustrate why opportunity costs are a useful and important concept for evaluators.

I believe the economist's concept of "opportunity costs" offers several benefits to evaluators who are conducting cost-benefit analysis or who wish to integrate cost effectiveness and value considerations into professional evaluation work. Although the concept may seem confusing at first, opportunity cost is simply another way of determining the true, full cost of any activity or action by considering the value of the next-best alternative that was traded off or forsaken in the course of selecting the chosen activity. To economists, the value of something does not refer to an outlay or expenditure in the way that most people think of the cost of a loaf of whole

wheat bread as being the \$2.50 they hand over to the cashier at the grocery store. Instead, economists are concerned with efficient use of resources, which means that cost should be considered in light of what could have otherwise been obtained with the same resource expenditure—in this case perhaps the oatmeal bread, or tortillas, or other product that you could have put your limited resources toward if you had not decided on getting the whole wheat bread.

On the surface this may seem trivial since, after all, we obviously prefer the wheat bread and many of us could easily afford to purchase both the loaf of wheat bread and the tortillas. However, as the situation grows more complex—as is typically the case in the course of professional evaluations of school programs, public policy, or business activities—knowing the full opportunity cost becomes much more important. This is because, as evaluators, we seek to determine whether or not our evaluand is not only doing *good* or *bad*, but also whether it is doing as well as possible. This requires a conceptual understanding of what else the evaluand could be putting their limited resources toward, regardless of whether or not the current policy or activity is effective.

Take for example a personal evaluation of a simple decision to quit your job and return to graduate school for a master's degree. A simple approach to conducting a cost-benefit analysis

of the situation could be to look at only the out of pocket cost—two years of tuition and living expenses—and the benefit—a better-paying job after graduation. If the price of tuition is \$15,000 per year and the estimated post-degree salary boost is \$20,000 per year, it would appear that the benefit of increased salary would cover the cost of tuition in only one and a half years, making the return to college a pretty easy decision. However, if you were already earning an annual salary of \$100,000, then the *true* cost of returning to school is really much higher. With an understanding of the concept of opportunity cost you would see that the master's degree would not cost \$30,000 but \$230,000—the full total of money spent, plus the opportunity forsaken to earn an annual salary. Of course, returning to school may still be a good decision, depending on the number of working years expected, but the best decision will be made only when opportunity costs are considered.

The power of the opportunity cost concept extends beyond the capturing of full activity costs, however, and is perhaps more useful when considering the costs of an activity for which there is not an established monetary value. In simple terms, the concept of opportunity cost is how we each make a daily determination of how to utilize the limited resource of time. For the graduate student in the previous example, the decision as to whether to spend Saturday afternoon studying or to hang out at the beach will involve a very real cost, even if no money ever changes hands. Once again, in the more complex situations that professional evaluators encounter, considering the opportunity cost becomes even more important. As an example, imagine that a local volunteer organization decides to spend the summer handing out government aid packages to families left homeless by a major flood. On the surface it would appear difficult to assess the total cost of such an activity, beyond incidental cash expenditures associated with the activity. However, if this volunteer group

typically spends the summer repairing inner-city homes there is a very real cost in the form of this alternate activity that did not occur. This is not to say that the tradeoff may or may not be the correct one to make—depending on the determination of *need* and the values of the volunteer group—but that costs are very real even in situations where no money changes hands and no additional resources are expended.

Of course, this discussion of the usefulness of opportunity costs would be incomplete without addressing the criticisms of Scriven from the last issue of JMDE, which I feel are mainly issues of misunderstanding or misinterpreting the economist's view. On the basic point of defining "opportunity costs" Scriven got it right, stating that "the cost of X is defined as the value of the most valuable alternative that had to be forsaken in order to obtain X."¹ The cost of something is what was given up to get it, which may or may not always include money or other tangible resources that are actively handed over to a seller. However, Scriven criticizes the basic definition as requiring a prior knowledge of the benefits of a given alternate course of action, which he asserts is a "logical flaw." While it is true that, at the very least, an estimate of the benefits of the alternative is required, this does not seem like an undue burden since both individuals and organizations are routinely required to assess the value of such alternatives when making decisions. But more importantly, Scriven's criticism is overly focused on the economist's concept of "opportunity costs" as a *definition of cost*² in a dictionary or identity sense. In reality,

¹ Unless otherwise noted, all mentions of Scriven in this article refer to: Scriven, M. (2008). The economist's fallacy. *Journal of MultiDisciplinary Evaluation*, 5(9), 74-76.

² I can't speak for all economists, but I'd be willing to guess that most are perfectly accepting of the Merriam-Webster (2008) definition of the term "costs", which is the "loss or penalty incurred in gaining something." When economists define costs as being "equal to the most valuable forsaken alternative" it is done in an

the logical concept of “opportunity costs” was not created as a way of defining what cost *is*, but to measure the true cost of an activity without resorting to the flawed approach of only measuring the resources (money, time, etc) given up in pursuing any given choice.

To economists, the expenditure of resources is of less importance, since in the real world all resources (time, money, energy, etc) are both fixed and limited. If this were not the case, then costs would be of no concern anyway. Instead, economists are more interested in how the resources are used—e.g. are they used to the greatest utility, in the most efficient manner. For professional evaluators, this should also be of great concern, since we are tasked with drawing a similar conclusion regarding how any given evaluand has performed. Ideally, an organization should not only show that it is successfully doing good in terms of its own goals, but also doing as much good as possible, given its resource pool. For example, a local non-profit housing organization that uses its \$1 million annual budget to build 10 homes may appear to be doing a good job of providing homes for low-income families; however, if the same resources could otherwise have been used to rehabilitate 15 homes, it would be apparent that the organization is not taking the most efficient approach to creating housing opportunities.

Perhaps the greater problem in addressing opportunity cost, though, is a misunderstanding of what exactly the forsaken alternatives are in a situation where the present state is undesirable. In the last issue of JMDE, Scriven offered an example of human pain, which would seem to pose a difficult condition for which to measure the cost. However, it becomes much easier if one realizes that *the absence of pain*, in and of itself, is not a forsaken alternative; instead, what the pain-stricken cancer patient in Scriven’s example has foregone is the *treatment necessary to eliminate pain combined with the experience of an*

absence of pain. The concept might seem confusing, since certainly existing in a state of persistent pain is a negative experience for human beings. However, clearly the treatment (which could include life-risking surgery or powerful drugs that may cause other health problems) is a worse deal for the patient, who forsakes the next best opportunity of treatment (that includes both the negatives of treatment with some balancing positive of diminished pain) and instead selects remaining in pain.

Another way of looking at the negative costs of a situation is that there are none. No one makes a choice to get cancer or have their house washed away by a flood—it just happens without requiring any resources or decisions of the victim. Instead, costs come into play when the decision is made to seek treatment for the cancer or to rebuild after the storm. Alleviating the negative effects of an event can have a real and often large cost in terms of forsaken alternatives. For example, those who are currently still rebuilding in New Orleans are giving up vacations, early retirements, leisure time, and many other valuable pastimes to restore their homes and businesses. This is the opportunity cost of the conditions caused by Hurricane Katrina—a cost that in reality far exceeds the accounting costs of money spent on rebuilding the city.

In short, evaluators should not shy away from making the effort to understand and properly use the opportunity cost concept in the course of professional evaluation practice. It offers extreme flexibility by allowing a comparative assessment of costs in situations where the monetary value of a decision has not been, or can not be easily established. In cases where quantitative monetary values are known, looking at opportunity costs ensures that the true cost of a decision is captured and not just the direct resource expenditure—such as in cases where money directly spent is measured without considering the total amount of money spend and foregone.

attempt to provide a functional definition for normative analysis.

Most importantly, opportunity costs reflect the fact that our world's resources are limited; therefore every decision made involves giving up another potential path of action. As evaluators, we should strive to make sure that these limited resources are being used in the most efficient, effective manner possible by the individuals and organizations that rely on our assessments.