ThoughtCo.

What Are Opportunity Costs?

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Unlike most costs discussed in economics, an opportunity cost doesn't necessarily involve money. The opportunity cost of any action is simply the next best alternative to that action: What you would have done if you didn't make the choice that you made? The notion of opportunity cost is critical to the idea that the true cost of anything is the sum of all the things that you have to give up.

Opportunity cost considers only the next best alternative to an action, not the entire set of alternatives, and takes into account all of the differences between the two choices.

We actually deal with the concept of opportunity cost every day. For example, options for a day off work might include going to the movies, staying home to watch a baseball game, or going out to coffee with friends. Choosing to go to the movies means the opportunity cost of that action is the second choice.

Explicit Versus Implicit Opportunity Costs

Generally, making choices includes two types of cost: explicit and implicit. Explicit costs are monetary expenses, while implicit costs are intangible and therefore hard to account for. In some cases, such as weekend plans, the notion of opportunity cost includes only these forgone alternatives, or implicit costs. But in others, such as a business's profit maximization, opportunity cost refers to the difference in the total of this type of implicit cost and the more typical explicit monetary cost between the first choice and the next best alternative.

Analyzing Opportunity Costs

The concept of opportunity cost is particularly important because, in economics, almost all business costs include some quantification of opportunity cost. To make decisions, we must consider benefits and costs, and we often do this through marginal analysis. Firms maximize profits by weighing marginal revenue against marginal cost.

What will make the most money when considering the operating costs? The opportunity cost of an investment would involve the difference between the return on the chosen investment and the return on the other investment.

Likewise, individuals weigh personal opportunity costs in everyday life, and these often include as many implicit costs as explicit. For example, weighing job offers includes analyzing more perks than just wages. A higher-paying job isn't always the chosen option because when you factor in benefits like health care, time off, location, work duties, and happiness, a lower-paying job might be a better fit. In this scenario, the difference in wages would be part of the opportunity cost, but not all of it. Likewise, working additional hours at a job offers more in wages earned but comes at the expense of more time to do things outside of work, which is an opportunity cost of employment.