



# WHY ECONOMICS?

## CONCEPT #1 BENEFIT/COST ANALYSIS

### What students should know about economics and why: 6 Key Ideas

#### #1 Benefit/Cost Analysis – a fundamental tool for getting the most from our resources

The most fundamental analytical tool of economics is benefit/cost analysis. The basic economic question is how to make the best use of scarce resources to achieve our goals—whether they are individual or social goals.

From a student’s perspective, an important question is. “How do I make the best use of my most important resource (human capital) to achieve my short and long term goals? How do I improve my human capital? And what are the benefits and costs of doing so?”

As they begin learning to use this powerful analytical tool, students initially learn to set goals. Next, they must realize that they all have skills; knowledge, experience, and personal characteristics that will help them achieve their goals. These characteristics are called human capital. Once students have identified their goals and the resources available to achieve those goals, it’s time to investigate alternatives. What are some different ways to use their resources to achieve their goals? Next, they evaluate the advantages and disadvantages of the alternatives. Finally, they decide and identify the cost of the choice --- the alternative given up. When they select a choice, they also identify the **opportunity** given up (the opportunity cost).

For example, a student wants to maximize her well-being by having as much fun as possible and getting sufficient grades to get into a good college. How should she use her human capital to achieve the goal of maximizing her well-being? Should she use ten hours of her human capital to get a part time job and save the money to buy and maintain a car or should she use her human capital for studying? The goal is to maximize her well-being. The resource is ten hours of her human capital. The two alternative ways to maximize her well-being are to use her human capital to **study** or to **work** part time. Studying will give her good grades but it is a lot of effort and sometimes pretty boring. The advantages of working are that it will get her the car with its independence and fun. The disadvantage of working is that it is tiring and the car will be expensive when she includes maintenance, insurance, and gasoline. She chooses

**studying** and gets the good grades she hoped for (**benefits**). She gave up the **opportunity** to **work** (**cost**) to have a car with its independence and fun. She could have used her human capital to study or to work for a car. Her **choice** was studying; her (**opportunity**) **cost** was working.

Mastery of benefit/cost analysis allows students to investigate the following questions:

- Will my goals take me where I want to go?
- How do I improve my human capital? And what are the benefits and cost of doing so?
- How will an employer use benefit/cost analysis to decide whether to hire me or not?
- Am I making the best use of my human capital to achieve my goals?
- Should I go to college after high school or straight to work?
- Should I buy a particular car now or save to buy a better car later?
- Should I buy health insurance or save my money for unexpected expenses?

Benefit/cost analysis is not only a powerful tool for personal decision making, but also an analysis that should be applied in making or understanding decisions made by producers/business and policymakers or voters.

- How will an employer use benefit/cost analysis to decide whether to hire an extra worker or not?
- What goals are policymakers attempting to pursue and are they using the best methods to achieve the goals?
- Should we have minimum wage laws and at what level? Price controls? Environmental protections?
- What is the most effective way to protect endangered species?
- Where should our limited educational resources go, early childhood education or gifted and talented programs?

In analyzing social policy, benefit cost analysis is necessary but not always sufficient. In discussing the minimum wage, for example, it is important to identify the benefits and costs involved but it is as important to identify who gains the benefits and who pays the cost. Minimum wage workers who remain working will enjoy higher incomes, but those who lose their jobs will not. With international trade policy, often domestic producers gain and domestic consumers lose. This distribution of benefits and costs is essential in analyzing social policy.

Benefit/Cost analysis can be used to analyze historical decisions. No incident can be explained without examining the goals of the actors, the incentives that drove them, and the reasons for their actions as opposed to alternative actions. That is where the application of benefit/cost analysis is useful. To study the human experience without investigating the thought process of the individuals involved is to gain less than a complete picture. Economics is essential in any study of the human experience. Historical events are not simply a series of actions, places and dates, but a series of decisions made by individuals based on goals and alternatives. To understand these decisions, students must understand the goals and alternatives of the decision makers. For example, colonists had to decide whether to side with the

King or the rebels. Each one weighed her/his benefits and costs and made a choice. Decisions by all major and minor historical characters can be understood with benefit/cost analysis.

Students can also see the role that the quest for resources has played in other human experiences. Many migrations can be explained as a search for resources where migrants measured the hoped for benefits of reaching a new place with better resources against the things they were giving up (opportunity cost) in leaving their homeland. In most cases, migration occurs when the opportunity cost of leaving is low; when migrants have little to lose.

Benefit/cost analysis is the major tool used by economists to explain the past, analyze the present, and predict the future; it can and should be an integral part of students' thinking as they make personal and social decisions in the context of the U.S. political-economic system in a global society.

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