Making Decisions: Cost-Benefit Analysis

In a world of scarcity, people try to pick the alternative that provides the greatest benefit at the lowest cost.

Before we discuss how people evaluate and make decisions, let's review some important concepts:

Scarcity: You can't have everything you want.

Alternatives: Different options from which you can choose.

Choice: Because you can't have everything you want, you have to make choices from a list of alternatives.

Tradeoffs: Choices involve giving up something to get something. All choices have consequences, both positive and negative.

Opportunity Cost: A resource can only be allocated to one thing at a time. The opportunity cost of deciding to do one thing is the next best alternative use of the resource. All choices have opportunity costs. A good idea is only good if its value is greater than its opportunity cost.

Economists use the term cost-benefit analysis to describe how people evaluate alternatives. We weigh the potential costs versus the potential benefits. Example: "Should I go to McDonalds for lunch?"

Cost-Benefit Analysis: Is it worth it? Are the positive aspects of the action greater than the negative aspects? Is it a "good deal?" Analyzing positive and negative aspects of potential decisions forces you to think more carefully about your choices.

When we compare the costs and benefits of two or more alternatives side-by-side, we are doing a comparative cost-benefit analysis. People will try to pick the alternative that provides the greatest benefit at the lowest cost. Example: "McDonalds is OK, but what about Wendy's?"

Comparative Cost-Benefit Analysis: Even if it is a good deal, is this the best deal? Is this the best use of limited resources? Putting the decision in the context of all alternative uses of your resources helps you see your world in its completeness.

And when we compare the benefits and the costs of continuing to do something, we are doing a marginal cost-benefit analysis. Marginal in this context means additional or incremental. Example: "I went to McDonalds and I've already had one Big Mac ... should I get another?"

Marginal Cost-Benefit Analysis: Marginal analysis has many applications and is useful in both personal and social decision making. The concept of margin allows you to answer all types of questions, such as: Should I super-size that value meal? How much should I study and how much TV should I watch? How much is too much, how much is not enough? Comparing marginal costs with marginal benefits is an important part of the economic way of thinking and leads to rational decision making. Economics (and common sense) tells us that if the marginal benefits of an action are greater than the marginal costs, then we should do it.