Fast Easy Accounting Opportunity Cost Reference Guide

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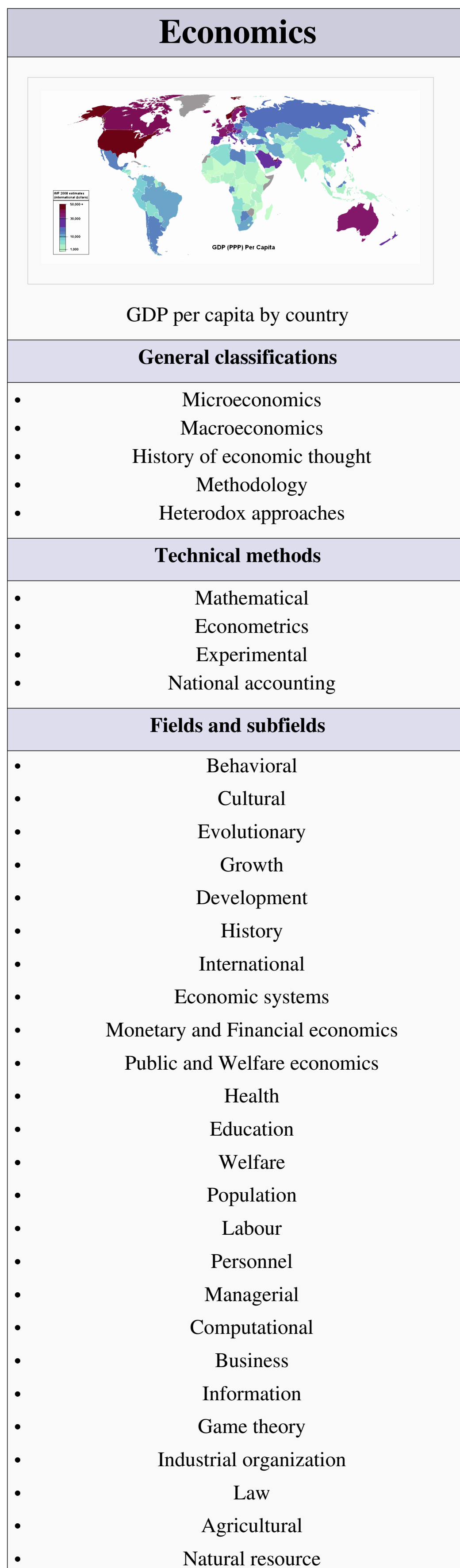
Opportunity cost



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In microeconomic theory, the **opportunity cost** of a choice is the value of the best alternative forgone, in a situation in which a choice needs to be made between several mutually exclusive alternatives given limited resources. Assuming the best choice is made, it is the "cost" incurred by not enjoying the benefit that would be had by taking the second best choice available.[1] The *New Oxford American Dictionary* defines it as "the loss of potential gain from other alternatives when one alternative is chosen". Opportunity cost is a key concept in economics, and has been described as expressing "the basic relationship between scarcity and choice".[2] The notion of opportunity cost plays a crucial part in ensuring that scarce resources are used efficiently.[3] Thus, opportunity costs are not restricted to monetary or financial costs: the real cost of output forgone, lost time, pleasure or any other benefit that provides utility should also be considered opportunity costs.

History

The term was coined in 1914 by Austrian economist Friedrich von Wieser in his book *Theorie der gesellschaftlichen Wirtschaft*.[4] It was first described in 1848 by French classical economist Frédéric Bastiat in his essay "What Is Seen and What Is Not Seen [5]".

Opportunity costs in consumption

Opportunity cost may be expressed in terms of anything which is of value. For example, an individual might decide to use a period of vacation time for travel rather than to do household repairs. The opportunity cost of the trip could be said to be the forgone home renovation.[*citation needed*]

Opportunity costs in production

Opportunity costs may be assessed in the decision-making process of production. If the workers on a farm can produce either one million pounds of wheat or two million pounds of barley, then the opportunity cost of producing one pound of wheat is the two pounds of barley forgone (assuming the production possibilities frontier is linear). Firms would make rational decisions by weighing the sacrifices involved.

Explicit costs

Explicit costs are opportunity costs that involve direct monetary payment by producers. The opportunity cost of the factors of production not already owned by a producer is the price that the producer has to pay for them. For instance, a firm spends $100 on electrical power consumed, their opportunity cost is $100. The firm has sacrificed $100, which could have been spent on other factors of production.

Implicit costs

Implicit costs are the opportunity costs in factors of production that a producer already owns. They are equivalent to what the factors could earn for the firm in alternative uses, either operated within the firm or rent out to other firms. For example, a firm pays $300 a month all year for rent on a warehouse that only holds product for six months each year. The firm could rent the warehouse out for the unused six months, at any price (assuming a year-long lease requirement), and that would be the cost that could be spent on other factors of production.

Non-monetary opportunity costs

Opportunity costs are not always monetary units or being able to produce one good over another. The opportunity cost can also be unknown, or spawn a series of infinite sub opportunity costs. For instance, an individual could choose not to ask a girl out on a date, in an attempt to make her more interested ("playing hard to get"), but the opportunity cost could be that they get ignored - which could result in other opportunities being lost.

Evaluation

Note that opportunity cost is not the *sum* of the available alternatives when those alternatives are, in turn, mutually exclusive to each other – it is the value of the *next best* use. The opportunity cost of a city's decision to build the hospital on its vacant land is the loss of the land for a sporting center, or the inability to use the land for a parking lot, or the money which could have been made from selling the land. Use for any one of those purposes would preclude the possibility to implement any of the other.

References

[4]

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[5] http://www.econlib.org/library/Bastiat/basEss1.html

External links

- The Opportunity Cost of Economics Education (http://www.nytimes.com/2005/09/01/business/01scene.html) by Robert H. Frank
- Opportunity Cost Example & Analysis (http://www.youtube.com/watch?v=ezOdQUzLVAo)

Factors of production

In economics, **factors of production** are the *inputs* to the production process. *Finished goods* are the *output*.

Input determines the quantity of output i.e. output depends upon input. Input is the starting point and output is the end point of production process and such input-output relationship is called a production function. There are three *basic* (AKA classical) factors of production: Land, Labor, Capital. All three of these are required in combination at a time to produce a commodity. In economics, production means creation or an addition of utility. Factors of production (or productive 'inputs' or 'resources') are any commodities or services used to produce goods or services

'Factors of production' may also refer specifically to the 'primary factors', which are stocks including land, labor (the ability to work), and capital goods applied to production. Materials and energy are considered secondary factors in classical economics because they are obtained from land, labor and capital. The primary factors facilitate production but neither become part of the product (as with raw materials) nor become significantly transformed by the production process (as with fuel used to power machinery). 'Land' includes not only the site of production but natural resources above or below the soil. The factor land may, however, for simplification purposes be merged with capital in some cases (due to land being of little importance in the service sector and manufacturing). Recent usage has distinguished human capital (the stock of knowledge in the labor force) from labor.[1] Entrepreneurship is also sometimes considered a factor of production.[2] Sometimes the overall state of technology is described as a factor of production.[3] The number and definition of factors varies, depending on theoretical purpose, empirical emphasis, or school of economics.[4]

Historical schools and factors

In the interpretation of the currently dominant view of classical economic theory developed by neoclassical economists, the term "factors" did not exist until after the classical period and is not to be found in any of the literature of that time.[5]

Differences are most stark when it comes to deciding which factor is the most important. For example, in the Austrian view—often shared by neoclassical and other "free market" economists—the primary factor of production is the time of the entrepreneur, which, when combined with other factors, determines the amount of output of a particular good or service. However, other authors argue that "entrepreneurship" is nothing but a specific kind of labor or human capital and should not be treated separately. The Marxian school goes further, seeing labor (in general, including entrepreneurship) as the primary factor of production, since it is required to produce capital goods and to utilize the gifts of nature. But this debate is more about basic economic theory (the role of the factors in the economy) than it is about the definition of the factors of production.

Physiocracy

In French Physiocracy, the main European school of economics before Adam Smith, the productive process is explained as the interaction between participating classes of the population. These classes are therefore the **factors of production** within physiocracy: capital, entrepreneurship, land, and labor.

- *The farmer* labors on land (sometimes using "crafts") to produce goods.
- *The landlord* is only a consumer of food and crafts and produces nothing at all.
- *The merchant* labors to export food in exchange for foreign imports.

Classical

The classical economics of Adam Smith, David Ricardo, and their followers focuses on physical resources in defining its factors of production, and discusses the distribution of cost and value among these factors. Adam Smith and David Ricardo referred to the "component parts of price"[6] as the costs of using:

An advertisement for labour from Sabah and Sarawak, seen in Jalan Petaling, Kuala Lumpur.

- Land or natural resource — naturally-occurring goods such as water, air, soil, minerals, flora and fauna that are used in the creation of products. The payment for use and the received income of a land owner is rent.
- Labor — human effort used in production which also includes technical and marketing expertise. The payment for someone else's labor and all income received from ones own labor is wages. Labor can also be classified as the physical and mental contribution of an employee to the production of the good(s).
- The capital stock — human-made goods which are used in the production of other goods. These include machinery, tools, and buildings.

The classical economists also employed the word "capital" in reference to money. Money, however, was not considered to be a factor of production in the sense of capital stock since it is not used to directly produce any good. The return to loaned money or to loaned stock was styled as interest while the return to the actual proprietor of capital stock (tools, etc.) was styled as profit. See also returns.

Marxian

Marx considered the "elementary factors of the labor-process" or "productive forces" to be:

- Labor ("work itself")
- The subject of labor (objects transformed by labor)
- The instruments of labor (or means of labor).[7]

The "subject of labor" refers to natural resources and raw materials, including land. The "instruments of labor" are tools, in the broadest sense. They include factory buildings, infrastructure, and other human-made objects that facilitate labor's production of goods and services.

This view seems similar to the classical perspective described above. But unlike the classical school and many economists today, Marx made a clear distinction between labor actually done and an individual's "labor power" or ability to work. Labor done is often referred to nowadays as "effort" or "labor services." Labor-power might be seen as a stock which can produce a flow of labor.

Labor, not labor power, is the key factor of production for Marx and the basis for Marx's labor theory of value. The hiring of labor power only results in the production of goods or services ("use-values") when organized and regulated (often by the "management"). How much labor is actually done depends on the importance of conflict or tensions within the labor process.

Neoclassical economics

Neoclassical economics, one of the branches of mainstream economics, started with the classical factors of production of land, labor, and capital. However, it developed an alternative theory of value and distribution. Many of its practitioners have added various further factors of production (see below).

Further distinctions

Further distinctions from classical and neoclassical microeconomics include the following:

- **Capital —** This has many meanings, including the financial capital raised to operate and expand a business. In much of economics, however, "capital" (without any qualification) means goods that can help produce other goods in the future, the result of investment. It refers to machines, roads, factories, schools, infrastructure, and office buildings which humans have produced in order to produce goods and services.
- **Fixed capital —** This includes machinery, factories, equipment, new technology, factories, buildings, computers, and other goods that are designed to increase the productive potential of the economy for future years. Nowadays, many consider computer software to be a form of fixed capital and it is counted as such in the National Income and Product Accounts of the United States and other countries. This type of capital does not change due to the production of the good.
- **Working capital —** This includes the stocks of finished and semi-finished goods that will be economically consumed in the near future or will be made into a finished consumer good in the near future. These are often called inventories. The phrase "working capital" has also been used to refer to liquid assets (money) needed for immediate expenses linked to the production process (to pay salaries, invoices, taxes, interests...) Either way, the amount or nature of this type of capital usually changed during the production process.
- **Financial capital —** This is simply the amount of money the initiator of the business has invested in it. "Financial capital" often refers to his or her net worth tied up in the business (assets minus liabilities) but the phrase often includes money borrowed from others.
- **Technological progress —** For over a century, economists have known that capital and labor do not account for all of economic growth. This is reflected in *total factor productivity* and the *Solow residual* used in economic models called *production functions* that account for the contributions of capital and labor, yet have some unexplained contributor which is commonly called *technological progress*. Ayres and Warr (2009) present time series of the efficiency of primary energy (exergy) conversion into useful work for the US, UK, Austria and Japan revealing dramatic improvements in model accuracy. With useful work as a factor of production they are able to reproduce historical rates of economic growth with considerable precision and without recourse to exogenous and unexplained technological progress, thereby overcoming the major flaw of the Solow Theory of economic growth.[]

A fourth factor?

As mentioned, recent authors have added to the classical list. For example, J.B. Clark saw the co-ordinating function in production and distribution as being served by entrepreneurs; Frank Knight introduced managers who co-ordinate using their own money (financial capital) and the financial capital of others. In contrast, many economists today consider "human capital" (skills and education) as the fourth factor of production, with entrepreneurship as a form of human capital. Yet others refer to intellectual capital. More recently, many have begun to see "social capital" as a factor, as contributing to production of goods and services.

Entrepreneurship

Consider entrepreneurship as a factor of production, leaving debate aside. In markets, entrepreneurs combine the other factors of production, land, labor, and capital, in order to make a profit. Often these entrepreneurs are seen as innovators, developing new ways to produce and new products. In a planned economy, central planners decide how land, labor, and capital should be used to provide for maximum benefit for all citizens. Of course, just as with market entrepreneurs, the benefits may mostly accrue to the entrepreneurs themselves.

The word has been used in other ways. The sociologist C. Wright Mills refers to "new entrepreneurs" who work within and between corporate and government bureaucracies in new and different ways.[8] Others (such as those practicing public choice theory) refer to "political entrepreneurs," i.e., politicians and other actors.

Much controversy rages about the benefits produced by entrepreneurship. But the real issue is about how well institutions they operate in (markets, planning, bureaucracies, government) serve the public. This concerns such issues as the relative importance of market failure and government failure.

Non tangible forms of capital

Human capital

Contemporary analysis distinguishes tangible, physical, or nonhuman capital goods from other forms of capital such as human capital. Human capital is embodied in a human being and is acquired through education and training, whether formal or on the job.

Human capital is important in modern economic theory. Education is a key element in explaining economic growth over time (see growth accounting). It is also often seen as the solution to the "Leontief paradox" in international trade.

Intellectual capital

A more recent coinage is intellectual capital, used especially as to information technology, recorded music, written material. This intellectual property is protected by copyrights, patents, and trademarks.

This view posits a new Information Age, which changes the roles and nature of land, labour, and capital. During the Information Age (circa 1971–present), the Knowledge Age (circa 1991 to 2002), and the Intangible Economy (2002–present) many see the primary factors of production as having become less concrete. These factors of production are now seen as knowledge, collaboration, process-engagement, and time quality.

According to economic theory, a "factor of production" is used to create value and allow economic performance. As the four "modern-day" factors are all essentially abstract, the current economic age has been called the Intangible Economy. Intangible factors of production are subject to network effects and the contrary economic laws such as the law of increasing returns.[9]

Social capital

Social capital is often hard to define, but to one textbook - Microeconomics in Context - it is:

> the stock of trust, mutual understanding, shared values, and socially held knowledge that facilitates the social coordination of economic activity.[10]

Knowledge, ideas, and values, and human relationships are transmitted as part of the culture. This type of capital cannot be owned by individuals and is instead part of the common stock owned by humanity. But they are often crucial to maintaining a peaceful society in which normal economic transactions and production can occur.

Another kind of social capital *can* be owned individually.[11] This kind of individual asset involves reputation, what accountants call "goodwill", and/or what others call "street cred," along with fame, honor, and prestige. It fits with Pierre Bourdieu’s definition of "social capital" as:

> an attribute of an individual in a social context. One can acquire social capital through purposeful actions and can transform social capital into conventional economic gains. The ability to do so, however, depends on the nature of the social obligations, connections, and networks, available to you.[12]

This means that the value of individual social assets that Bourdieu points to depend on the current "social capital" as defined above.

Natural resources

Ayres and Warr (2009) are among the economists who criticize orthodox economics for overlooking the role of natural resources and the effects of declining resource capital.[] See also: *Natural resource economics*

Energy

Energy can be seen as individual factor of production, with an elasticity larger than labor.[13] A cointegration analysis support results derived from linear exponentional (LINEX) production functions.[14]

Notes

[1] Paul A. Samuelson and William D. Nordhaus (2004). *Economics*, 18th ed., "Factors of production", "Capital", Human capital", and "Land" under Glossary of Terms.

[3] Parkin, the very minute. Michael and Esquivel, Gerardo, *Macroeconomía', Addison Wesley, 5ed (1999), p. 160.*

[5] Classical price theory follows "costs of reproduction" and does not allow for "factor" gains. The great questions of Rent, Wages, and Profits must be explained by the proportions in which the whole produce is divided between landlords, capitalists, and labourers, and which are not essentially connected with the doctrine of value. (Ricardo, David,1820; 1951, "The Works and Correspondence of David Ricardo", edited by Piero Sraffa, 10 Volumes, Cambridge: Cambridge University Press 1951–1955, VIII, p. 197.

[6] Adam Smith (1776), *The Wealth of Nations*, Smith: Wealth of Nations | Library of Economics and Liberty (http://www.econlib.org/LIBRARY/Smith/smWN.html) B.I, Ch.6, Of the Component Parts of the Price of Commodities in paragraph I.6.9.

[7] "Das Kapital", chapter 7, section 1.

[8] "White Collar: The American Middle Classes," 1956. Oxford: Galaxy Books, pp. 94-100.

[9] It is, therefore, important to differentiate between conventional (tangible) economics and intangible economics when discussing issues related to factors of production which change according to the economic era that society is experiencing. For example, *land* was a key factor of production in the Agricultural Age.

[10] Neva Goodwin, Julie A. Nelson, Frank Ackerman, and Thomas Weisskopf, 2005. "Microeconomics in Context," p. 124

[11] Joel Sobel. 2002. Can We Trust Social Capital? Journal of Economic Literature. 40(1) March, pp. 139-54.

[12] quoted in Sobel.

[13] R. Kümmel: The Productive Power of Energy and its Taxation (http://energiesteuer.net/artikel/pdf_artikel/portotalk.pdf), 4th European Congress Economics and Management of Energy in Industry, Porto, Portugal, 27.-30. Nov. 2007.

[14] R. Stresing, D. Lindenberger, R. Kümmel: Cointegration of Output, Capital, Labor, and Energy (http://www.ewi.uni-koeln.de/fileadmin/user_upload/Publikationen/Working_Paper/EWI_WP_08-04_Cointegration-of-Output.pdf), European Physical Journal B, Vol 66, No 2, Nov. 2008, 279-287.

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Capital (economics)

Financers

In economics, **capital goods**, or **real capital** are already-produced durable goods that are used in production of goods or services. The capital goods are not significantly consumed, though they may depreciate in the production process. Capital is distinct from **land** in that capital must itself be produced by human labor before it can be a factor of production. At any moment in time, total physical capital may be referred to as the **capital stock** (which is not to be confused with the capital stock of a business entity.) In a fundamental sense, capital consists of any produced thing that can enhance a person's power to perform economically useful work—a stone or an arrow is capital for a caveman who can use it as a hunting instrument, and roads are capital for inhabitants of a city. Capital is an input in the production function. Homes and personal autos are not capital but are instead durable goods because they are not used in a production effort.

In Marxist political economy,[1] capital is money used to buy something only in order to sell it again to realize a financial profit, and for Marx capital only exists within the process of economic exchange—it is wealth that grows out of the process of circulation itself and for Marx it formed the basis of the economic system of capitalism. This concept is also called financial capital in economics.

In narrow and broad uses

In classical and neoclassical economics, capital is one of the factors of production. The others are land, labour and, according to some proponents, organization, entrepreneurship, or management. Goods with the following features are capital:

- It can be used in the production of other goods (this is what makes it a factor of production).
- It was produced, in contrast to "land", which refers to naturally occurring resources such as geographical locations minerals.
- It is not used up immediately in the process of production unlike raw materials or intermediate goods. (The significant exception to this is depreciation allowance, which like intermediate goods, is treated as a business expense.)

These distinctions of convenience have carried over to contemporary economic theory.[2][3] There was the further clarification that capital is a stock. As such, its value can be estimated at a point in time. By contrast, investment, as production to be added to the capital stock, is described as taking place over time ("per year"), thus a flow.

In Marxian economics, there are distinctions between different forms of capital:

- Constant capital, which refers to capital goods,
- Variable capital, which refers to labor-inputs, where the cost is "variable" based on the amount of wages and salaries are paid throughout the duration of an employee's contract/employment,
- Fictitious capital, which refers to intangible representations or abstractions of physical capital, such as stocks, bonds and securities (or "tradeable paper claims to wealth").

Earlier illustrations often described capital as physical items, such as tools, buildings, and vehicles that are used in the production process. Since at least the 1960s economists have increasingly focused on broader forms of capital. For example, investment in skills and education can be viewed as building up human capital or knowledge capital, and investments in intellectual property can be viewed as building up intellectual capital. These terms lead to certain questions and controversies discussed in those articles. Human development theory describes human capital as being composed of distinct social, imitative and creative elements:

- Social capital is the value of network trusting relationships between individuals in an economy.

- Individual capital, which is inherent in persons, protected by societies, and trades labour for trust or money. Close parallel concepts are "talent", "ingenuity", "leadership", "trained bodies", or "innate skills" that cannot reliably be reproduced by using any combination of any of the others above. In traditional economic analysis individual capital is more usually called *labour*.

Further classifications of capital that have been used in various theoretical or applied uses include:

- Financial capital, which represents obligations, and is liquidated as money for trade, and owned by legal entities. It is in the form of capital assets, traded in financial markets. Its market value is not based on the historical accumulation of money invested but on the perception by the market of its expected revenues and of the risk entailed.
- Public capital, which encompasses the aggregate body of government-owned assets that are used to promote private industry productivity, including highways, railways, airports, water treatment facilities, telecommunications, electric grids, energy utilities, municipal buildings, public hospitals and schools, police, fire protection, courts and still others.
- Natural capital, which is inherent in ecologies and protected by communities to support life, e.g., a river that provides farms with water.
- Spiritual capital, which refers to the power, influence and dispositions created by a person or an organization’s spiritual belief, knowledge and practice.

In part as a result, separate literatures have developed to describe both natural capital and social capital. Such terms reflect a wide consensus that nature and society both function in such a similar manner as traditional industrial infrastructural capital, that it is entirely appropriate to refer to them as different types of capital in themselves. In particular, they can be used in the production of other goods, are not used up immediately in the process of production, and can be enhanced (if not created) by human effort.

There is also a literature of intellectual capital and intellectual property law. However, this increasingly distinguishes means of capital investment, and collection of potential rewards for patent, copyright (creative or individual capital), and trademark (social trust or social capital) instruments. Capital (all types collectively) is often the tool that is leveraged in order to build wealth both personal and corporate. Capital is the willingness to work and incur a profitable market earnings

Endowment

Endowment is the natural state of something, before it is processed. The production turns an endowment into capital. Just as capital can be split into natural capital etcetera, so endowment can also be split into a country's natural endowment or a population's endowment.[4]

Interpretations

Some thinkers, such as Werner Sombart and Max Weber, locate the concept of capital as originating in double-entry bookkeeping, which is thus a foundational innovation in capitalism, Sombart writing in "Medieval and Modern Commercial Enterprise" that:[5]

> The very concept of capital is derived from this way of looking at things; one can say that capital, as a category, did not exist before double-entry bookkeeping. Capital can be defined as that amount of wealth which is used in making profits and which enters into the accounts."

Within classical economics, Adam Smith (*Wealth of Nations*, Book II, Chapter 1) distinguished fixed capital from circulating capital. The former designated physical assets not consumed in the production of a product (e.g. machines and storage facilities), while the latter referred to physical assets consumed in the process of production (e.g. raw materials and intermediate products). For an enterprise, both were types of capital.

Karl Marx adds a distinction that is often confused with David Ricardo's. In Marxian theory, variable capital refers to a capitalist's investment in labor-power, seen as the only source of surplus-value. It is called "variable" since the amount of value it can produce varies from the amount it consumes, *i.e.*, it creates new value. On the other hand, constant capital refers to investment in non-human factors of production, such as plant and machinery, which Marx takes to contribute only its own replacement value to the commodities it is used to produce. It is constant, in that the amount of value committed in the original investment, and the amount retrieved in the form of commodities produced, remains constant.

Investment or capital accumulation, in classical economic theory, is the production of increased capital. Investment requires that some goods be produced that are not immediately consumed, but instead used to produce other goods as capital goods. Investment is closely related to saving, though it is not the same. As Keynes pointed out, saving involves not spending all of one's income on current goods or services, while investment refers to spending on a specific type of goods, *i.e.*, capital goods.

Austrian School economist Eugen von Böhm-Bawerk maintained that capital intensity was measured by the roundaboutness of production processes. Since capital is defined by him as being goods of higher-order, or goods used to produce consumer goods, and derived their value from them, being future goods.

Further reading

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[4] http://www.econlib.org/cgi-bin/searchbooks.pl?searchtype=BookSearchPara&id=bbPTC&query=endowment

[5] (quoted in "Accounting and rationality" (http://www.dse.unive.it/summerschool/course2007/accounting and rationality.pdf))

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