BY JOHN A. ALLISON

PRESIDENT'S MESSAGE

Opportunity Cost

The Cato Institute's mission is to expand the understanding of public policies based on the principles of limited government, free markets, individual liberty, and peace. One difficulty in making our case for policy change is helping the public understand a fundamental concept called opportunity cost. Opportunity cost is the potential return one could earn if you were doing something different. As a simple example, if a business has a product line that produces a 6 percent return on investment and there is a different product line that produces a 10 percent return on investment, the business should shift resources to the higher-returning product line (other things being equal).

In fact, every decision in life has an opportunity cost. If you choose to go to a movie, you may be losing the opportunity to take a walk in the park. While opportunity cost is an easily understood idea, in many decisions individuals choose to ignore it. This occurs often in a business where employees have a vested interest in an existing low-return activity despite the fact that a higher-return investment is clearly available. Businesses struggle or fail by ignoring opportunity cost.

At the societal level, opportunity cost is a very important issue. The current economic recovery is a classic example. It is very difficult for most people to understand the radical difference in economic well-being between 2 percent growth and 5 percent growth compounded even over just five years. Many people assume the stimulus package, increased regulations, and the Federal Reserve's quantitative easing are critical to a recovery. They do not understand that a normal recovery is 5 percent growth and not 2 percent, and that these government interventions radically slowed growth. Cato senior fellow Alan Reynolds recently wrote an excellent article on this issue in the *Wall Street Journal*, "Demand-Side Policy Gave Us the Big Economic Fizzle."

It is difficult for individuals to understand the damage the FDA does when it delays or stops drug development. It is easy to see when someone dies from the misuse of a medicine, but many cannot visualize the loss of life from bureaucratic delays. It is hard to grasp that the market would develop a rational quality control alternative (like Underwriters Laboratories, in electrical products) if the FDA did not exist. People have an emotional reaction to a single death from an unexpected effect of a drug, while it takes a conceptual leap—or an economics class—to see all the lives that could be saved without the FDA.

Parents who send children to very poor schools are sometimes aware of the opportunity cost of government schools and thus support charter schools. Middle-class parents who send their children to mediocre schools are often unaware of the opportunity cost that their children are paying. We are then surprised that a poorly educated middle class has relatively declining income.

Good teachers in government schools support their unions' efforts to stop school competition. They fail to grasp the opportunity cost to them from the lack of competition. In a competitive education market, good teachers would be in strong demand and would be paid more. Public school unions protect mediocre and poor teachers.

People see the benefits paid from Social Security. They have a hard time understanding that a like amount of savings properly invested would have created dramatically more income and more capital, driving faster economic growth. Underfunding is a critical issue for Social Security; however, it is only one symptom of the problem. Social Security proceeds have been spent by government. The opportunity cost of incentivizing government spending through governmental Social Security instead of incentivizing private savings is tremendous. If Social Security had allowed private savings, American taxpayers wouldn't be facing trillions of dollars in unfunded liabilities.

People often see the world through the lens of the status quo. They cannot grasp how much better things could be if different opportunities were pursued. Fortunately, in private markets, entrepreneurs who do see the opportunities make them visible to the rest of us—Steve Jobs, Sam Walton, and Bill Gates are examples. This is one reason free markets radically outperform statism. Unfortunately, the average voter has difficulty seeing what is possible—seeing the opportunities. And the average voter elects the politicians who set government policy. One of our tasks at Cato is to help individuals understand the opportunity cost of government interference in both economic markets and in the denial of civil liberties.

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