

Study Guide



Chapter 18, Section 2

For use with textbook pages 410–414

Making Economic Decisions



KEY TERMS

trade-off the alternative you face when you decide to do one thing rather than another (page 410)

opportunity cost the cost of the next best use of your time or money when you choose to do one thing rather than another (page 411)

marginal cost the extra cost of producing one additional unit of output (page 412)

marginal benefit the extra benefit associated with an action (page 413)

cost-benefit analysis an economic model that compares the marginal costs and marginal benefits of a decision (page 413)

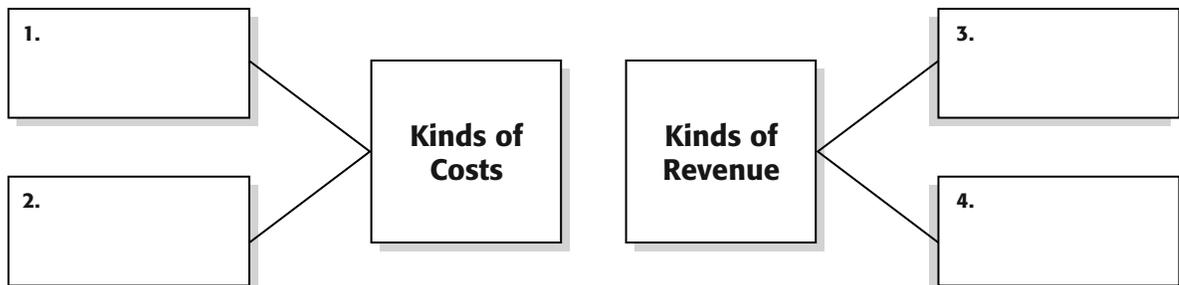
DRAWING FROM EXPERIENCE

Think of the decisions you have to make when deciding how to spend your time. How does your decision to do one thing affect other things you may want to do?

The last section described the choices that need to be made when making economic decisions. This section discusses the trade-offs involved in making choices.

ORGANIZING YOUR THOUGHTS

Use the diagram to help you take notes. People who own businesses have to know how much of a good or service to produce. They have to consider the costs and revenues. In the diagram, list the kinds of costs and revenue they have to consider and describe each one.



Study Guide**Chapter 18, Section 2 (continued)****READ TO LEARN****• Trade-Offs** (*page 410*)

Scarcity forces people to make choices about how they will use resources. To make economic decisions, people have to take into account all the costs and benefits of an action. When people make economic choices, they exchange one good or service for another. For example, when people buy DVD players, they exchange money for the right to own a DVD player rather than something else that might cost the same. The alternative you face if you decide to do one thing rather than another is called a **trade-off**.

There are many trade-offs in life. For example, taking time to study for a test means having less time to be with friends. Spending time with friends means less time for studying. Trade-offs also occur on a larger scale. For example, when a nation decides to put more money into education, it has less money available for medical research. People are forced to make trade-offs every time they choose to use their resources in one way instead of another.

Suppose a person buys a CD. The cost to the person is more than the price of the CD. Another cost is not having money to buy a sweater that the person wanted. This measure of cost is called **opportunity cost**. It is what people cannot buy or do when choosing to do one thing rather than another. Opportunity cost includes more than money. It also includes the possible discomforts connected to the choice made. For example, the opportunity cost of cleaning house is not just the cost of cleaning products. It also includes the time a person spends cleaning rather than doing other things like listening to music.

People who own a business that produces goods need to know how much of the good to produce. They have to look at costs and revenues. All businesses have costs. Some costs are *fixed costs*. These include the expenses that are the same no matter how many units of a good are produced. Mortgage payments are examples of fixed costs. Some costs are *variable costs*. These are expenses that change with the number of products produced. Wages are examples of variable costs. They will increase as production increases and decrease when production decreases. Total costs involve adding variable costs to fixed costs. Many businesses focus on average total cost. To arrive at this, they divide the total cost by the quantity produced.

Study Guide



Chapter 18, Section 2 (continued)

Another important concept is **marginal cost**. This is the extra cost of producing one additional unit of output. For example, suppose the total cost of producing 30 helmets is \$1,500. Producing 31 helmets results in a total cost of \$1,550. This means that the marginal cost of the additional unit is \$50.

Businesses need to know what amount of output will produce the greatest profits. They use two key measures of revenue to decide this. The first is total revenue. This is the number of units sold multiplied by the average price per unit. Another measure of revenue has to do with finding out how revenue will change as a result of a change in output. **Marginal revenue** is the change in total revenue that results from selling one more unit of output.

People generally do something because they expect to get some benefit. They are concerned with the **marginal benefit**, or the extra benefit associated with an action.

- 5. What is the difference between fixed costs and variable costs?

• **Cost-Benefit Analysis** (page 413)

Once the marginal costs and benefits of a decision are known, economists analyze the decision by creating an economic model called a **cost-benefit analysis**. It compares the marginal costs and marginal benefits of a decision. In making decisions, it is best to choose an action in which the benefits are greater than the costs. For example, suppose a farmer has to decide how much of his 25 acres to plant with wheat. Some land is better for growing wheat than other land. The farmer first plants the land that will produce the most wheat per acre. As more land is planted, the farmer has to use land that is less productive. In this case the marginal benefits start to diminish. The farmer has to decide how many acres to plant so that the extra benefit is greater than the extra cost.

Study Guide



Chapter 18, Section 2 (continued)

As the example shows, a cost-benefit analysis can be used to decide how much to produce. It can also be used to decide what to produce and for whom to produce it.

6. In general, what kind of action is best in making economic decisions?
