PAGE ONE Economics NEWSLETTER

the back story on front page economics

"Choices Are Everywhere: Why Can't We Just Have It All?"

January 2013

Classroom Edition

An informative and accessible economic essay with a classroom application.

Includes the full version of the Page One Economics Newsletter, *plus questions for students and an answer key for classroom use.*

Common Core Standards (see page 10)

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Prepared by Scott A. Wolla
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NEWSLETTER

January ■ 2013

Choices Are Everywhere: Why Can't We Just Have It All?

Scott A. Wolla, *Senior Economic Education Specialist*

"*You can't always get what you want.*"—The Rolling Stones

The public debate about the best way to reduce the level of **government debt** highlights our difficult situation: Our wants greatly exceed our ability to pay for them. In the case of government, purchases require current revenue through taxation or borrowing; the fiscal cliff arose from a level of debt caused by wanting more (and purchasing more) than we can pay for.

If we wish to reduce debt, we must make difficult choices. One choice is to cut government spending on goods and services—but which spending priorities should be cut? The other choice is to raise taxes—but who should pay more?

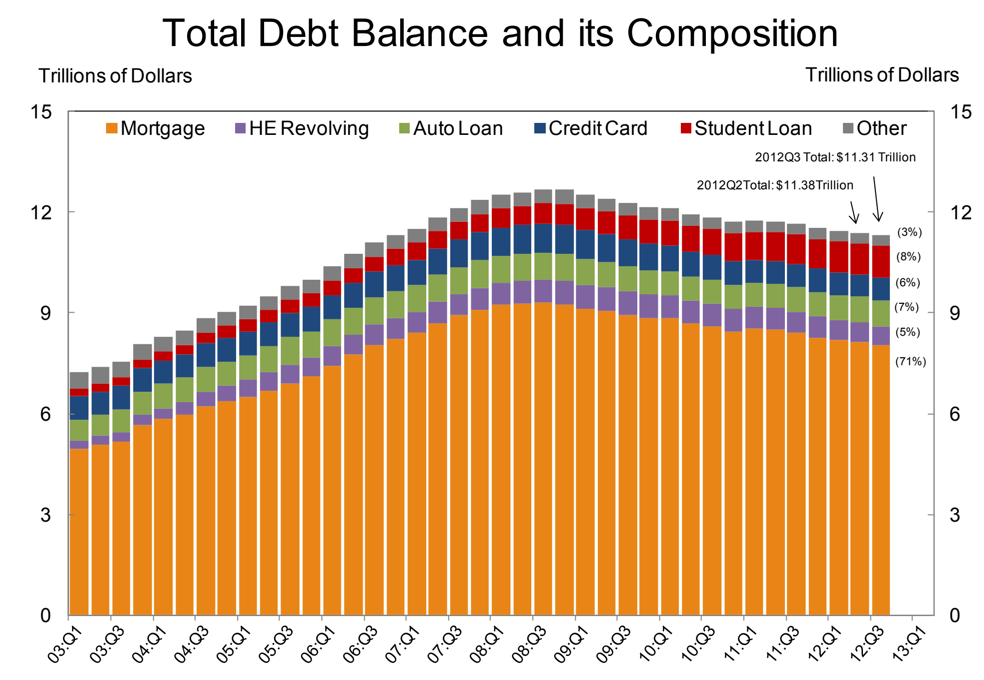
You might prefer one choice or the other or a combination of both. In fact, you may have very similar thoughts about your personal or family budget. These issues are based on understanding the economic concepts of *scarcity* and *opportunity cost*.

Personal and Household Spending

Let's use a specific example to get a better grasp of these ideas. Suppose you receive a $20 gift card during the holidays. The $20 limit acts like a budget that constrains your spending. In other words, your resources are limited. How about your wants? Are they limited? If you are like most people, they are not—you would like to have much more than you can afford. This condition of limited resources and unlimited wants is called **scarcity**. The $20 limit means that you can't have all the CDs, movies, or games you want; you must choose the one you want the most. Deciding between the recently released CD from your favorite band and the newest hit movie requires a choice, which involves an **opportunity cost**—the value of the next-best alternative when a decision is made. The opportunity cost is what is given up. So, choosing the CD from your favorite band means giving up the movie.

People make such decisions all the time. Managing a family budget is also an exercise in managing scarcity and opportunity costs. Household income determines the amount of money a family has to spend; that is, it constrains spending. And, unlike our gift card example, household wants are not limited to CDs, movies, and games. Rather, they include basics such as housing, medical care, education, food, and clothing. But, just like the gift card example, because our wants exceed our ability to spend, we must make choices, which involve opportunity costs. So, more money spent by a family on food might require less spent on clothing.

Credit cards and other forms of credit make it possible (and quite tempting) to exceed spending limits. Does debt negate scarcity? Does it permit you to buy more than your income would allow? It might seem so, but you still have a limit. Using debt means that you are borrowing your future income to buy goods today. As you repay the debt (plus interest) over time, you will have less income in the future to buy goods and services then. And remember that credit cards have limits, and



NOTE: The total level of household debt has decreased since 2008. While mortgages still represent the largest portion of household debt at $8.03 trillion, the level has been falling. Outstanding student loan balances have been growing and currently stand at $956 billion. HE, home equity.

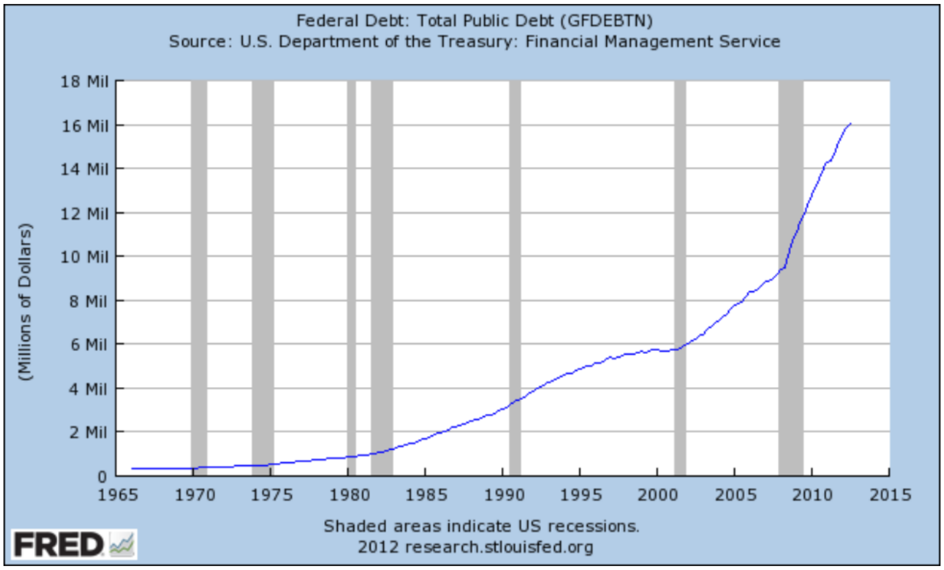
SOURCE: Federal Reserve Bank of New York Credit Panel/Equifax; http://www.newyorkfed.org/research/national_economy/householdcredit/DistrictReport_Q32012.pdf.

lenders avoid lending beyond the borrower's ability to repay the loan. At the end of the third quarter of 2012 (August 31), total consumer debt stood at $11.31 trillion (see first chart).

Government Spending

In many ways, the government faces these same choices. Citizens have collective wants and the government attempts to satisfy these wants through its spending. Social Security, health care programs such as Medicare and Medicaid, and national defense are among the top federal spending categories. But the ability to satisfy our society's wants is constrained by the level of government income, which is generated primarily by taxing workers and companies. Just like individuals who make spending choices, when the government chooses, there is an opportunity cost. If more money is spent on national security, the result might be less spending on health care. It is possible to raise taxes to provide additional income for the government to allocate, but that imposes further budget constraints on workers and companies who pay taxes—so, this policy choice also has opportunity costs. Of course, the government's spending is not limited to tax revenue. Just as families can, the government can use debt to pay for some of its goods and services. At the end of the third quarter of 2012 (August 31), total federal debt stood at $16.07 trillion (see second chart).

What is the downside of government debt? Using debt to buy goods and services today means the government is borrowing future income (that is, tax revenue)—which means less income in the future for buying goods and services then. In addition, there is a limit to how much credit lenders



NOTE: The total federal debt stood at $16.07 trillion at the end of the third quarter of 2012 (August 31); see http://research.stlouisfed.org/fred2/series/GFDEBTN. For an up-to-date view of the federal debt, see the U.S. Treasury's "The Debt to the Penny and Who Holds It:" www.treasurydirect.gov/NP/BPDLogin?application=np.

SOURCE: Federal Reserve Bank of St. Louis FRED database.

(or investors) will extend to a country; they will avoid lending beyond the government's ability or willingness to repay the loan or will do so only at very high interest rates.

Conclusion

An understanding of scarcity and opportunity cost is crucial to making good economic decisions. Remember that scarcity describes the condition in which our wants exceed the resources necessary to satisfy those wants. Scarcity requires us to make choices and choosing involves an opportunity cost—the value of the item given up when a choice is made. So, making wise (and sometimes difficult) choices requires considering the opportunity costs. ■

GLOSSARY

Government debt: The sum of accumulated budget deficits. Also known as national debt.

Opportunity cost: The value of the next-best alternative when a decision is made; it's what is given up.

Scarcity: The condition that exists because there are not enough resources to produce everyone's wants.

Page One Economics Newsletter from the Federal Reserve Bank of St. Louis provides an informative, accessible economic essay written by our economic education specialists, who also write the accompanying classroom edition and lesson plan. The newsletter and lesson plans are published 9 times per year, January through May and August through November.

Please visit our website and archives http://research.stlouisfed.org/pageone-economics/ for more information and resources.

Name____________________________________ Period________

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"Choices Are Everywhere: Why Can't We Just Have It All?"

After reading the article, answer the following questions.

1. State the difficult choices that government leaders face in solving our long-term budget problems:

1)

2)

2. Why does scarcity mean that people must choose?

3. Explain why choices involve opportunity costs.

4. How is a family budget an exercise in managing scarcity? What role does income play?

5. Why is it tempting to think that credit cards, and other forms of credit, negate scarcity?

6. What are the downsides of government debt?

Teacher's Guide

Federal Reserve Bank of St. Louis *Page One Economics Newsletter*:
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After reading the article, answer the following questions.

1. State the difficult choices that government leaders face in solving our long-term budget problems:

1) Cutting spending on goods and services. If this option is chosen, which spending priorities should be cut?

2) Raising taxes. If this option is chosen, who should pay more?

2. Why does scarcity mean that people must choose?

Scarcity describes the situation in which people have limited resources but nearly unlimited wants. In other words, people cannot satisfy all their wants with their limited resources. They must choose which goods and services to buy.

3. Explain why choices involve opportunity costs.

When a person makes a choice, there is always an option not chosen. The value of the next-best alternative is the opportunity cost.

4. How is a family budget an exercise in managing scarcity? What role does income play?

A family budget is a plan for managing income and spending. Families have wants that exceed the resources necessary to satisfy them all. As a result, choices must be made, which involves opportunity costs. Income determines the amount of money a family has available to spend; that is, it constrains spending.

5. Why is it tempting to think that credit cards, and other forms of credit, negate scarcity?

Credit allows people to spend more money than their income alone would determine, but it does not negate scarcity because the money must be paid back, which reduces future spending. In addition, credit cards have limits, and lenders avoid lending beyond the borrower's ability to repay the loan.

6. What are the downsides of government debt?

Using debt to buy goods and services today means government is borrowing future income (that is, tax revenue)—which means less income in the future for buying goods and services then. In addition, there is a limit to how much credit that lenders (or investors) will extend to a country; they will avoid lending beyond the government's ability or willingness to repay the loan or will do so only at very high interest rates.

For Further Discussion

Read the following or distribute the handout to your students; then lead a classroom discussion on scarcity and opportunity cost.

Consider the Opportunity Cost

Opportunity cost is a foundational concept in economics. It is also a key thinking skill in the practical art of daily decisionmaking. Unfortunately, people often fail to consider opportunity cost until they learn to use it as a thinking skill. Once you have mastered the idea of opportunity cost, you will think differently about all sorts of routine choices. The table shows a few examples.

This:	Becomes this:
I'm tired. I think I will sleep in this morning.	If I sleep in this morning, then I give up the opportunity to go to chemistry class.
This new video game is awesome, and it's only $40.	This new video game is awesome, but if I spend $40 on it, I give up the opportunity to spend it on _______________ or save it for _______________.

In the end, you might still decide to sleep in and buy the new video game, but recognizing the opportunity costs will increase your chances of making a rational decision.

Free Lunch?

Economists are fond of saying "There is no such thing as a free lunch." Of course, they are not talking about lunches literally. In fact, many people miss the point of this phrase. Imagine Fred is walking to school when he notices a sign on the front lawn of the high school: "Free lunch here today at noon." Fred is a little skeptical, but later that day he looks out the window and, sure enough, he sees a table with pizza and soda and a big sign that reads "Free." But Fred remembers his teacher saying "There is no such thing as a free lunch." Fred decides to ask his best friend, Frank, why the lunch is not free. Frank shrugs and responds, "Someone had to pay for it." While this is true, the real question is this: Why is the lunch not free for Fred?

What do you think?

While Fred might not have to pay money for the lunch, the lunch is not free for Fred; by choosing to attend the free lunch on the front lawn of the high school, he gives up the opportunity to pursue another option—perhaps eating in the cafeteria. Or maybe Fred intended to study at lunch. By attending the free lunch, he gives up study time. The "free" lunch might be Fred's best option, but he should recognize that there is a cost.

Consider this scenario:

You received $50 from your grandmother for your birthday. You decide to buy some new clothes. Because the money was a gift, you believe your new clothes are free. You could have, however, used the $50 to buy the new calculator required for your math class next semester. So, are the clothes you bought really free?

No. You chose to buy the clothing, but you gave up the opportunity to buy the calculator, which is your opportunity cost.

You Decide: Opportunity Cost or Consequence?

The difference between opportunity costs and consequences can be confusing. Remember that the *opportunity cost* is the value of the next-best alternative when a decision is made; it's what is given up. A *consequence* is a result or effect of an action or decision, and consequences may be positive or negative. While opportunity cost and consequences sound like similar ideas, they are not the same. One way to think about the difference is to remember that the opportunity cost occurs when the decision is made, while the consequences lie in the future.

Imagine you decide to go to college after you graduate from high school. If you choose to go to college, you give up the opportunity to get a full-time job—this is part of the opportunity cost of attending college. The consequences of your decision lie in the future, such as the higher income you will likely receive with a college degree.

- Choice: Go to college
- Opportunity cost: Full-time employment
- Consequence: Higher income in the future

Identify the opportunity cost and the consequence in this scenario: You have one dollar, which you have decided to use to buy a candy bar. Your favorite candy bar is GooeyNut followed closely by LuvChoc. Your dentist has warned you about your candy habits; he is fond of saying "Forget the Alamo, remember the Enamel."

In this scenario, you are likely to choose the GooeyNut candy bar. If so, the opportunity cost of your choice is LuvChoc. The consequence is the potential for cavities in your future.

- Choice: GooeyNut
- Opportunity cost: LuvChoc
- Consequence: Potential for cavities in the future

Handout

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- Choice: ______________________________
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- Consequence: ______________________________

Common Core State Standards

Grades 6-12 Literacy in History/Social Studies and Technical Subjects

- **Key Ideas and Details**

  RH.11-12.1: Cite specific textual evidence to support analysis of primary and secondary sources, connecting insights gained from specific details to an understanding of the text as a whole.

  RH.11-12.2: Determine the central ideas or information of a primary or secondary source; provide an accurate summary that makes clear the relationships among the key details and ideas.

- **Craft and Structure**

  RH.11-12.4: Determine the meaning of words and phrases as they are used in a text, including analyzing how an author uses and refines the meaning of a key term over the course of a text (e.g., how Madison defines *faction* in *Federalist* No. 10).