Opportunity Cost

Ag Decision Maker
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Opportunity cost is a useful concept when considering alternative places for using resources and assets. In situations where the owner's resources and assets are used in the business, it is the concept used in determining if the business is making a return over and above the cost of contributed resources.

The definition of opportunity cost is the income foregone by not using the resource or asset in its next best alternative. The opportunity cost concept is frequently associated with resources and assets that an individual or business owns. For example, if an individual owns 100 acres of farmland, he or she has the decision of either farming the land or renting it to a neighbor. If he or she farms the land, the opportunity cost is the income foregone by not renting it to a neighbor. If the cash rental rate is $200 per acre, the opportunity cost (income foregone) by farming the land and not renting it to the neighbor is $20,000 ($200 x 100 acres.) Unless the individual can generate net returns of more than $15,000 from farming the land, they are financially better off renting the land to the neighbor.

This example can be taken a step further. The land could be sold and the proceeds invested elsewhere. For example, if the farmland can be sold for $6,000 per acre and the proceeds put in an alternative investment that returns 5%, the income foregone (opportunity cost) for either farming the land or renting it to a neighbor is $30,000 ($6,000 x 100 acres x 5%).

If you are contributing your labor to a value-added business, the opportunity cost is the income foregone by not employing the labor elsewhere. For example, if you are working full-time in your own value-added business and the value of your labor is $40,000 in the job market, the opportunity cost is the $40,000 foregone by not being employed.

The opportunity cost concept can looked at in various ways. The opportunity cost of making a decision to invest is the satisfaction given up by not making a consumption decision. For example, the opportunity cost of investing in an ethanol plant may be the satisfaction given up by not buying a new pickup. There is a fine line between investment decisions and consumption decisions in the farm business.

Additional Information

Visit the [Ag Decision Maker website](www.extension.iastate.edu/agdm) for additional resources on economic and business analysis concepts, www.extension.iastate.edu/agdm/vdanalysis.html#concepts.

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