Opportunity Cost and the Federal Budget

**Essential Question:**

- What role should opportunity cost play in making choices about the federal budget?

**Introduction:**

After reading about opportunity cost, students will identify alternative solutions, trade-offs made in choosing each alternative, and the opportunity cost of selecting each alternative in deciding the federal budget. Students will describe trade-offs as they make choices about the federal budget, including how to address the national debt.

**Key Information**

The following terms and concepts are used in this lesson:

- opportunity cost
- trade-offs
- debt
- choice
- deficit
- taxation
- scarcity
- substitute goods
- complementarity goods
- choices
- alternatives
- cost/benefit analysis

**Background**

Opportunity cost is the value of goods or services measured in terms of what had to be sacrificed (the next best alternative) in order to obtain the item or service. There is *always* an opportunity cost when choosing among alternatives. Choices must be made because, in relation to what we might want, resources are scarce.
Students Will Understand:

- Solutions to the problem of the budget deficit and national debt involve trade-offs and may affect groups differently.
- Decisions made to reduce the budget deficit and national debt will involve choices and trade-offs.
- Multiple perspectives on how to deal with the federal budget, national debt, and budget deficit have many sources.
- Individuals have a vested interest in addressing our nation’s fiscal challenges.

Students Will Be Able To:

- Support positions with evidence.
- Formulate a position or course of action on an issue.
- Evaluate the implementation of a decision.
- Recognize, explain, and analyze causes and consequences.

Related Curriculum Standards:

- Council for Economic Education National Standards
  
  **Standard 1: Scarcity**
  Productive resources are limited. Therefore, people cannot have all the goods and services they want; as a result, they must choose some things and give up others.

  **Standard 2: Marginal Cost/Benefit**
  Effective decision-making requires comparing the additional costs of alternatives with the additional benefits. Most choices involve doing a little more or a little less of something: few choices are “all or nothing” decisions.

  **Standard 4: Role of Incentives**
  People respond predictably to positive and negative incentives.

  **Standard 16: Role of Government**
  There is an economic role for government in a market economy whenever the benefits of a government policy outweigh its costs. Governments often provide for national defense, address environmental concerns, define and protect property rights, and attempt to make markets more competitive. Most government policies also redistribute income.

  **Standard 17: Using Cost/Benefit Analysis to Evaluate Government Programs**
  Costs of government policies sometimes exceed benefits. This may occur because of incentives facing voters, government officials, and government employees, because of actions by special interest groups that can impose costs on the general public, or because social goals other than economic efficiency are being pursued.

List of Lesson Resources:

1. Transition Scenario
2. National Budget Activity
3. Two Excerpts from Reports on Balancing the Federal Budget
Time Required:

2 class periods

Entry:

Discussion about Choices and Alternatives (20 minutes)

Students should list 3 spending/savings choices they recently made in rank order. Next to those choices, students should list the next best alternative foregone with each choice—the next best choice they didn’t make: for example, a cell phone purchase, what they did Saturday night, a job or college choice. Students should be prepared to explain the rationale for the decisions they made. You might model this activity first, listing 3 real or hypothetical choices they made. Alternatively, you might do the activity at the same time the students are doing it. Either way, it will be interesting for students to see how someone at a different stage of life goes through this same process with decisions about home repairs, job decisions, vacations, college costs, or medical expenditures.

Ask several students about their choices, alternatives, and rationales for their choices. As the students provide examples, make a list of their examples on the board. After several students have given examples, explain that the next best alternative they did not choose is their opportunity cost. If they did not do so at the beginning, they should share their hypothetical choices so that students can analyze the parallel process at a different stage of life. Opportunity cost is the value of goods or services measured in terms of what had to be sacrificed (the next best alternative) in order to obtain the item or service. There is always an opportunity cost when choosing among alternatives. Choices must be made because, in relation to what we might want, resources are scarce.

Ask students to decide whether or not their spending/saving choices were wise. What criteria might students use to decide whether or not a spending/saving decision is wise? List these criteria on the board and help students understand that a variety of contextual factors play a role in an individual’s economic decisions and in evaluating whether or not they were wise.

Lesson Activities and Strategies:

Transition Scenario (from individual decision to public policy decision) (30 minutes)

Have students read the scenario available in Resource 1.

Ask students to consider what they have just learned about opportunity cost and list their top two choices. After tallying the results, list the most popular choices and ask students to comment on the opportunity costs of the most popular options. Ask students to elaborate on their observations and look for chances to discuss differences of opinion. If students have difficulty engaging, lead them in a more directed way using the following questions:

- What is the opportunity cost of the most popular option? (the next most popular option)
- What factors should the principal consider when making his or her choice?
After reviewing some student choices and related opportunity costs, discuss what opportunity costs the principal must take into account when making his or her decision. (demands of teachers and staff, conditions of the library and computer lab, wishes of the school board, input of parents and community members, etc.)

- After identifying opportunity costs, discuss what opportunity costs the principal should bear in mind in making a final decision.
- Can the same first choice represent different opportunity costs to different people? Would it be important to understand that in trying to make a decision as a group? (Emphasize that in making a decision that meets the needs of multiple people—or is negotiated—people can arrive at the same place for different reasons.)

**National Budget Activity (30 minutes)**

See Resource 2.

**Closure: (20 minutes)**

**Debriefing of National Budget Activity**

The teacher asks each group to report on their top six decisions. The teacher or student assistant records the decisions on the board. The teacher then goes back to each group and the reporter goes over how and why the groups made their allocations.

The discussion should include:

- What were the most difficult choices? Why?
- What opportunity cost was simply too “big” in deciding to address the national debt?
- Besides changes in spending, should we raise taxes to pay the national debt? What would be the opportunity cost of raising taxes to pay the national debt?

**Assessment:**

The teacher provides two perspectives (Center on Budget and Policy Priorities and the Heritage Foundation) on how to address the national debt, including raising taxes to increase revenue. These perspectives are available in Resource 3. In a 250-500-word essay, students will identify the choice and opportunity cost of the recommendations.

**Further Engagement (Optional):**

Students should be encouraged to contact their elected federal representatives and present their opinion on how to best address the national debt. Students may call 1-800-VOTE-SMART or visit www.votesmart.org for easy-to-access information about their representatives and governmental agencies.
What role should opportunity cost play in making choices about the federal budget?

References Cited:


ECONOMICS

Opportunity Cost and the Federal Budget

Resources

The following section is formatted for the easy reproduction of resources intended for use by students. They appear in the order in which they are listed in the Introduction and are essential to the lesson. These resources may also be downloaded from the Understanding Fiscal Responsibility website: http://understandingfiscalresponsibility.org/
Resource 1. Transition Scenario

The principal of your school has asked the graduating senior class for its input on how to spend $10,000 that the school received from an anonymous donor. The anonymous donor requests that the money be used for only one purpose. Some seniors want the money for a senior class trip and some want the money to go to renovating the outdated senior lounge, the library, or the computer lab. Meanwhile, others want to donate it to the athletics department for a new van, and some suggest donating the gift to the teachers who have not received a pay raise in the last 5 years. The principal will choose between the two most popular choices after discussing the choices with the school board.


**Resource 2. National Budget Activity**

Directions (groups of 4): You and your partners have been asked to help create the $3.8 Trillion Federal Budget. You have been asked to rank these spending categories in priority order. For example, please place #1 next to the item that you would spend the most money on or next to the item to which you would add the most money. Indicate the total amount that you decide to allocate to each category of the federal budget. After completing your allocations, answer the questions below.

<table>
<thead>
<tr>
<th>Category</th>
<th>2010 Estimated Amount</th>
<th>Rank Order</th>
<th>Total Amount that You Allocate in 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mandatory Total</td>
<td>$2.28 trillion</td>
<td>N/A</td>
<td></td>
</tr>
<tr>
<td>Social Security</td>
<td>$720 billion</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Medicare and Medicaid</td>
<td>$726 billion</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other (includes Food Stamps, Unemployment Compensation, Child Nutrition and Tax Credits, Supplemental Security for the Disabled and Student Loans)</td>
<td>$620 billion</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest on Debt (Part of Mandatory)</td>
<td>$187 billion</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Discretionary Total</td>
<td>$1.2 trillion</td>
<td>N/A</td>
<td></td>
</tr>
<tr>
<td>Discretionary: Fixed</td>
<td>$573.0 billion</td>
<td></td>
<td></td>
</tr>
<tr>
<td>National Debt pay down</td>
<td>N/A</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Discretionary: Agriculture (e.g., animal and livestock management, agricultural biotechnology, food safety, and National School Lunch program)</td>
<td>$20.8 billion</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Discretionary: Defense (e.g., military health care, military intelligence, military pay, weapons, and equipment)</td>
<td>$515.4 billion</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Discretionary: Education (e.g., early childhood programs, community college programs, student grants and loans, and equal opportunity programs)</td>
<td>$45.4 billion</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Discretionary: National Science Foundation (e.g., Advanced Technological Education program, Graduate Research Fellowships, high-end computer facilities, and engineering programs)</td>
<td>$6.9 billion</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### Understanding Fiscal Responsibility

<table>
<thead>
<tr>
<th>Category</th>
<th>2010 Estimated Amount</th>
<th>Rank Order</th>
<th>Total Amount that You Allocate in 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discretionary: Veterans Affairs (e.g., VA hospitals and clinics, disability compensation, and survivor’s benefits)</td>
<td>$44.8 billion</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Discretionary: Housing and Urban Development (e.g., affordable home assistance programs, first-time home buyer programs, and rental assistance programs)</td>
<td>$38.5 billion</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Discretionary: Homeland Security (e.g., U.S. Customs and Border Protection and TSA)</td>
<td>$37.6 billion</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Discretionary: NASA (e.g., space exploration, scientific discovery, and aeronautics research)</td>
<td>$17.6 billion</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Discretionary: Interior (e.g., National Parks Service, New Energy Frontier program, and Special Trustee for American Indians)</td>
<td>$10.6 billion</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Discretionary: Treasury (e.g., Alcohol and Tobacco Tax and Trade Bureau, Community Development Financial Institution Fund, Internal Revenue Service, U.S. Mint)</td>
<td>$12.5 billion</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Discretionary: Energy (e.g., bio-energy programs, cyber security programs, nuclear safety programs, and Office of Energy Efficiency and Renewable Energy)</td>
<td>$25.0 billion</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

1. For which three programs did you increase allocations? Why?
2. What were the opportunity costs of increasing these allocations?
3. For which three programs did you decrease allocations? Why?
4. What were the opportunity costs of decreasing these allocations?
5. What were the most difficult decisions to make? Why?
6. Did you allocate funding to pay down the national debt? How much? Why or why not?
7. What were the opportunity costs of paying down the national debt?
What role should opportunity cost play in making choices about the federal budget?

Resource 3. Two Excerpts from Reports on Balancing the Federal Budget

Center on Budget and Policy Priorities
http://www.cbpp.org/cms/index.cfm?fa=view&id=3049

- **Upcoming tax policy decisions will have a major impact on the size of the problem.** If policymakers were to allow all of the 2001 and 2003 tax cuts to expire as scheduled at the end of 2010—or fully offset the cost of extending those tax cuts they choose to extend—this alone would shrink the fiscal gap by almost two-fifths, from 4.9 percent of GDP to 3.0 percent. The effect is this substantial because the budgetary benefits would start almost immediately (in 2011), and those benefits would reduce projected interest payments by a growing amount with each passing decade. But even if Congress were to allow all of the tax cuts to expire or to offset the full cost of extending them (which is extremely unlikely), the budget would still remain on an unsustainable long-run path.

- **The recession and programs enacted to spur economic recovery are not an important factor with regard to the long-term fiscal problem.** CBO forecasts that the economy will return to its potential by 2013. As a result, the deep recession that the nation is now experiencing is not responsible for a significant portion of the long-run budget gap. Nor are the policies that Congress enacted in response to the recession; the American Recovery and Reinvestment Act enacted in February 2009 has added only very slightly to the long-run gap, because its provisions are strictly temporary. Likewise, additional expenditures to support economic recovery of the magnitude that is now being considered would have only a tiny effect on the long-term picture.

- **Federal spending for programs other than the “big three” is not responsible for the long-term imbalance.** Total spending for all federal programs other than Medicare, Medicaid, and Social Security—which includes federal entitlement programs other than these “big three”—is projected to shrink as a share of the economy in coming decades. These programs will consume a smaller share of the nation’s resources in 2050 than they do today. As a result, they are not part of the cause of the long-term fiscal problem. Statements that we face a general “entitlement crisis” thus are mistaken.

The bottom line is that, as the economy recovers, policymakers should begin to implement a balanced approach to addressing the nation’s long-term fiscal problem, through a combination of sustained reforms of the U.S. health care system, reductions in federal expenditures, and increases in federal tax revenues.
Heritage Foundation

America’s fate is not yet sealed. This bleak future of rising spending, painful tax increases and unsustainable deficits can be avoided if lawmakers quickly take the following five steps:

1. Stop digging. Lawmakers must break their addiction to deficit spending. They should repeal the remaining stimulus funds, which have failed to create jobs and growth. Any new unemployment assistance should be offset by spending cuts elsewhere, as Sen. John Thune, South Dakota Republican, has proposed. Remaining TARP funds should be rescinded before they can be allocated to new spending. And most importantly, lawmakers must repeal ObamaCare, which any reasonable analysis exposes as a ticking time bomb for surging spending and deficits.

2. Cap spending growth. Washington has no enforceable spending caps. Discretionary spending has nearly doubled since Congress let its spending caps expire in 2002. Entitlement spending grows every year on autopilot. The repeated bypassing of “Pay As You Go” (PAY-GO) rules has rendered that budget constraint irrelevant. As long as Congress remains under pressure to spend, it needs spending caps to help it set priorities and make trade-offs. A law mandating that government cannot grow faster than the economy, personal income or inflation plus population growth, would create a budget process consistent with America’s budget priorities.

3. Reform Social Security, Medicare and Medicaid. These three programs are responsible for nearly all the growth in long-term deficits. As 10,000 baby boomers retire into these programs daily, there won’t be enough workers left to pay these benefits (especially as rising health care costs infect Medicare and Medicaid). Overall, Social Security and Medicare face an unfathomable $46 trillion unfunded obligation over the next 75 years. Simply put, the budget deficit will never significantly fall until these entitlements are reformed. Reform likely will mean raising the Social Security eligibility age faster than under current law. Upper-income retirees may be subject to mild income-testing of their Social Security benefits, as well as some reduction in their taxpayer subsidies for Medicare Parts B and D (which, unlike Medicare Part A benefits, are not “earned” through payroll taxes).

4. Empower states. Washington taxes families, subtracts a hefty administrative cost, and then sends the remaining tax revenues back to state and local governments, with specific rules dictating how they may spend the money. In that sense, Washington is merely an expensive middleman, contributing little more than meddling mandates that constrain the flexibility that state and local governments need to address their own issues creatively. Instead of performing many functions poorly, Congress should focus on performing a few functions well. Most highway, education, justice and economic development programs should be devolved to state and local governments, which will have the flexibility to tailor local programs to local needs (thus likely performing those functions at a lower taxpayer cost). Devolution also solves the earmark problem—if Alaska wants to build a “Bridge to Nowhere,” it can spend its own money on it, rather than take it from Minnesota’s bridge-repair funds.

5. Eliminate waste. While the deficit cannot be eliminated by cutting waste alone, Congress should pick this low-hanging fruit. For example, each year Washington loses $98 billion to payment errors, spends more than $90 billion on corporate welfare and pays $25 billion maintaining vacant federal properties. Cutting waste is also vital for Congress to begin building the public trust and credibility needed to undertake the larger reforms in Social Security and Medicare.