Personal budgeting and opportunity cost

Individuals face constraints when deciding how to spend limited income. In the example, a student receives $100 per month to spend on gas ($2 per gallon) and DVDs ($10 each). The combinations of these two goods that can be purchased are shown on a budget line, which represents all possible ways of spending the full income.

- On the budget line → you spend all $100 on gas and DVDs.
- Below the budget line → you spend less than $100, leaving money for savings or other items.
- Above the budget line → combinations are unattainable with the current income.

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Changes in income or prices shift the budget line:→

→ Higher income → shifts outwards (more goods affordable)

→ Lower income or higher prices → shifts inward (fewer goods affordable).

→ Lower prices (with same income) → shifts outward (more goods affor-dable).

Opportunity cost is the value of the alternative you give up.

- At current prices, each DVD ($10) costs the opportunity of 5 gallons of gas ($2 each).

- Conversely, each gallon of gas costs one-fifth of a DVD.

- Opportunity cost depends on relative prices, not just money prices. Even if prices rise equally (e.g., DVDs $20 and gas $4), the trade-off remains the same (1 DVD = 5 gallons of gas)