MADHESHIYA DEEPANJALI 2-53

1. Budget Constraint:

Individuals face limited income and must make choices on how to spend it.

Example: $100 monthly allowance to spend on gas ($2/gal) and DVDs ($10 each).

Only certain combinations of gas and DVDs are affordable, shown as points on a budget line (C1 to C5).

2. Budget Line:

Represents all possible combinations of two goods you can buy with your full income.

Points on or below the line are attainable; points above (e.g., C7) are unattainable.

Changes in income or prices shift the budget

Income increase: line shifts outward → more goods can be bought.

Price decrease: line shifts outward → greater quantity affordable.

Inflation or price increase: line shifts inward → fewer goods affordable.

3. Opportunity Cost:

Moving along the budget line shows trade-offs.

Example: Moving from C1 to C5, buying 1 extra DVD costs $10, which could have been spent on 5 gallons of gas.

Opportunity cost of each extra DVD = 5 gallons of gas.

Opportunity cost depends on price of the goods and quantity of the alternative item forgone, not just money.

4. General Insight:

Opportunity cost helps quantify the sacrifice made for each choice.

Even if prices change, the physical trade-off in terms of goods (e.g., DVDs vs gas) may remain

Understanding this helps in efficient allocation of limited resorce