# The Commonsense of Opportunity Cost

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THE discussion between Messrs Sen and Srinivasan in the columns of the Economic Weekly (September 29 & October 13) provides an occasion for some re-thinking on the doctrine of opportunity cost. Two definitions of opportunity cost have emerged from that discussion. The first refers to the marginal product of a factor in an alternative occupation; by almost unanimous consent this is taken to be nil or negligible for newly employed industrial workers in overpopulated agricultural countries. The second definition Is concerned with the compensation which must be received by a factor if it is to continue to offer its service to a firm; it is the minimum supply price that must be offered to a factory to keep it in its existing occupation. The former has figured prominently in discussions of the social costs of wiping out so-called disguised unemployment In underdeveloped countries, while the latter seems more relevant for the practical question as to whether new firms will at all grow up to take rare of the unemployed workers of the country.

In a fully employed economy, where all incomes are based on considerations of productivity the two definitions tend to coincide. Any lack of coincidence has to be explained., in such situations, either by reference to economic friction or in terms of the special attachment which particular occupations may have for specific groups of factors. The minimum supply price of factor X to occupation 1 may be higher than what it might earn by alternative use in occupation 2. In such a. case, the doctrine of opportunity cost, taken literally, fails to satisfy. The cost of the factor X to occupation 1 is something more than what it might earn or produce in an alternative use, for example, in occupation 2. The doctrine Is salvaged by broadening the definition of cost so as to include the. "net' advantages" of different kinds of occupations. The cost of a factor to an industry is the value of what it might produce elsewhere minus (or plus) the net advantages (to disadvanges) of this particular occupation as compared with its rivals.

In a society where Incomes are not based on a strict valuation of the marginal product, or where doles constitute a source of livelihood for some people, the relation between the two definitions is virtually snapped. The minimum supply price of labour to a" new firm may be equal to the full industrial wage. This is higher than what labour Is currently 'earning' in agriculture (his barest subsistence needs). That in turn is higher than what he contributes to production in his existing occupation. The difference between the labour cost to industry and the current earnings of labour in the rural areas has to be explained, 1 presume, by reference to the same non-economic factors as, were referred to in the previous paragraph. (There may be other explanations in terms of institutional obstacles to the mobility of labour, the existence of heterogeneous groups among rural workers, etc). On the other hand. the difference between labour campings in agriculture and the marginal product of the labourer has to be explained in terms of the institutional peculiarities of pre-capitalist agriculture.

How does the doctrine of opportunity cost emerge out of this ordeal? The cost of labour to an industry Is now equal to the value of its alternative product ('nil or negligible by all admission) supplemented up to the cost of subsistence (according to rural standards) plus the differential advantage of rural living as it. appears to the labourers themselves. The relation between the two definitions with which we started is no longer as self-evident as it was in our example of a fully employed capitalist society. But given the institutional structure of rural society and the peoples' attitude to industrial work, the two definitions are not. entirely unrelated. Once again the doctrine has to be salvaged, if at all, by broadening the definition so as to include in the displaced alternative the cost of the industrial workers.

One naturally loses faith in a doctrine which changes its character so frequently. Doubts have been expressed regarding the applicability and relevance of the doctrine in the theory of economic growth. If one sticks to the first definition of opportunity cost as the value of the alternative product, tha cost is nil, and the case for using up as much of tile labour as possible in highly labour-intensive occupations seems to be irresistible. But the cost of labour, or to put it more laboriously, the cost of providing employment to the unemployed is equal to the full industrial wage which, as we have seen is equal to the cost of subsistence plus the differential considered necessary by the labourers. Shall we adopt the second definition and say that the cost of employing labour is nothing but the opportunity cost as so defined? The former seems to be barren of all practical significance, while the latter looks suspiciously like circular reasoning.

To get out of this dilemma, one ran do no better than go back to first principles. The doctrine of opportunity cost, in the hands of its originators, was a device for showing forth the relation between private and social costs, Where a factor is capable of being used in two ways, its social cost in the first, use is measured by the value of its alternative product in the second. In this case the supply price *of* the factor to the first industry reflects the value of the "displaced alternative'. In terms of our two definitions, we can say that the second definition is a construct based on the first which represents the essence of the social cost of producing the particular product. Where no such alternative use is possible, the social cost is no longer the cost of a displaced alternative: the supply price of the factor ceases to deserve the name 'opportunity cost', since no oner opportunity of production exists. What does the supply price stand for? Does it reflect any social cost? I believe it does.

The minimum supply price of the disguised unemployed comprises, as we have seen, the cost of rural subsistence and a differential. The former is a fixed social obligation and is discharged by the family, the State, or some other agency. The latter is embedded In the existing system of valuation of the community. An employer who provides useful employment to the unemployed taKes overdue former obligation and has to pay an additional penally for investing in an industrial rather that an agricultural process. His private cost is a reflection of two separate social costs the cost of maintaining the unemployed and the cost of introducing an industrial process in a predominantly rural society, 'Neither of these is an opportunity cost, in the correct sense of the term. Both of these are, however; real social costs involved in an industrial investment process. The ancients would haw called them the costs of accumulation, of building" up the wages fund, and such costs would, in a Smithian economy, be accompanied by an additional item, viz, a rise in 'profit'. A rise in profit, if effective, would have transferred to the hands of the would-be employer a sufficient command over wage-goods to enable him to give useful employment to labour. In so far as the previous consumption of the disguised unemployed can be thus channelled into the wage fund, the cost of providing employment is not wholly a net cost. Hut a certain additional social cost must almost always be involved in creating fresh employment for the disguised unemployed. Even in the limiting case where labourers agree to work in industry for the rural subsistence and the whole of the previous consumption can be recovered, additional social cost is involved' In organising the fiscal and other necessary arrangements (e g transport). Against this additional cost we have to set the additional product from the new employment.