chapter:

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>> First Principles

Krugman/Wells

- A set of principles for understanding the economics of how individuals **make choices**
- A set of principles for understanding how individual **choices interact**
- A set of principles for understanding **economy-wide interactions**

Individual Choice

- **Individual choice** is the decision by an individual of what to do, which necessarily involves a decision of what not to do.

- Basic principles behind the individual choices:
  1. Resources are scarce.
  2. The real cost of something is what you must give up to get it.
  3. "How much?" is a decision at the margin.
  4. People usually take advantage of opportunities to make themselves better off.

Resources Are Scarce

- A **resource** is anything that can be used to produce something else.
  - Ex.: Land, labor, capital

- Resources are **scarce** – the quantity available isn’t large enough to satisfy all productive uses.
  - Ex.: Petroleum, lumber, intelligence

The Real Cost of Something Is What You Must Give Up to Get It

- The real cost of an item is its **opportunity cost**: what you must give up in order to get it.

- Opportunity cost is crucial to understanding individual choice:
  - Ex.: The cost of attending the economics class is what you must give up to be in the classroom during the lecture.

- Sleep? Watching TV? Rock climbing? Work?

- *All* costs are ultimately opportunity costs.

Opportunity Cost

I WOULD RATHER BE SURFING THE INTERNET

- In fact, everybody thinks about opportunity cost.
- The bumper stickers that say *"I would rather be … (fishing, golfing, swimming, etc…)"* are referring to the "opportunity cost."
- It is all about what you have to *forgo* to obtain your choice.

Got a Penny?

- At many cash registers there is a little basket full of pennies. People are encouraged to use the basket to round their purchases up or down.
- If it’s too small a sum to worry about, why calculate prices that exactly? Why do we have pennies?
- Sixty years ago, a penny was equivalent to 30 seconds worth of work—it was worth saving a penny if doing so took less than 30 seconds. But wages have risen along with overall prices, today a penny is therefore equivalent to just over 2 seconds of work—and so it’s not worth the opportunity cost of the time it takes to worry about a penny more or less.
- The rising opportunity cost of time in terms of money has turned a penny from a useful coin into a nuisance.

“How Much?” Is a Decision at the Margin

- You make a **trade-off** when you compare the costs with the benefits of doing something.
- Decisions about whether to do a bit more or a bit less of an activity are **marginal decisions**.

Marginal Analysis

- Making trade-offs *at the margin*: comparing the costs and benefits of doing a little bit more of an activity versus doing a little bit less.

- The study of such decisions is known as **marginal analysis**.
  - Ex.: Hiring one more worker, studying one more hour, eating one more cookie, buying one more CD, etc.

People Usually Take Advantage of Opportunities to Make Themselves Better Off

- An **incentive** is anything that offers rewards to people who change their behavior.
  - Ex.: Price of gasoline rises → people buy more fuel-efficient cars.
- There are more well-paid jobs available for college graduates with economics degrees → more students major in economics.
- People respond to these incentives.

Pay for Grades?

- A few years ago, some Florida schools offered actual cash bonuses to students who scored high on the state’s standardized exams.
- **Why?**
- To motivate the students to take the exams as seriously as the school administrators did (Florida introduced a pay-for-performance scheme for schools: schools whose students earned high marks on the state exams received extra state funds).
- **Did it work?**
- Yes. Some Florida schools that have introduced rewards for good grades on state exams report substantial improvements in student performance.

A Woman’s Work

- In 1900, only 6 percent of married women worked for pay outside the home.
- By 2005, the number was about 60 percent. This change is in part due to changing attitudes, invention, and the growing availability of home appliances, especially washing machines.
- In pre-appliance days, the opportunity cost of working outside the home was very high: it was something women typically did only in the face of dire financial necessity.
- With modern appliances, the opportunities available to women changed—and the rest is history.

Interaction: How Economies Work

Interaction of choices—my choices affect your choices, and vice versa—is a feature of most economic situations.

Principles that underlie the interaction of individual choices:

1. There are gains from trade.
2. Markets move toward equilibrium.
3. Resources should be used as efficiently as possible to achieve society's goals.
4. Markets usually lead to efficiency.
5. When markets don't achieve efficiency, government intervention can improve society's welfare.

There Are Gains From Trade

- In a market economy, individuals engage in **trade**: They provide goods and services to others and receive goods and services in return.

- There are **gains from trade**: people can get more of what they want through trade than they could if they tried to be self-sufficient.