First Principles
- 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
A set of principles for understanding the economics of how individuals make choices:

- Scarcity
- Opportunity cost
- Trade-offs
- Marginal analysis

A set of principles for understanding the economics of how individual choices interact:

- Trade
  - Gains from trade
  - Specialization
- Equilibrium
- Efficiency and equity
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.
“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
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 $\rightarrow$ people buy more fuel-efficient cars.

There are more well-paid jobs available for college graduates with economics degrees $\rightarrow$ more students major in economics.

People respond to these incentives.
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.
This increase in output is due to **specialization**: Each person specializes in the task that he or she is good at performing.

The economy, as a whole, can produce more when each person specializes in a task and trades with others.
Markets move toward equilibrium.

An economic situation is in **equilibrium** when no individual would be better off doing something different.

Anytime there is a change, the economy will move to a new equilibrium.

Ex.: What happens when a new checkout line opens at a busy supermarket?
Resources should be used as efficiently as possible to achieve society’s goals.

An economy is **efficient** if it takes all opportunities to make some people better off without making other people worse off.

Should economic policy makers always strive to achieve economic efficiency?

**Equity** means that everyone gets his or her fair share. Since people can disagree about what’s “fair,” equity isn’t as well-defined a concept as efficiency.
Efficiency vs. Equity

Ex.: Handicapped-designated parking spaces in a busy parking lot

A conflict between:

- **equity**, making life “fairer” for handicapped people, and
- **efficiency**, making sure that all opportunities to make people better off have been fully exploited by never letting parking spaces go unused.

How far should policy makers go in promoting equity over efficiency?
Markets usually lead to efficiency.

The incentives built into a market economy already ensure that resources are usually put to good use. Opportunities to make people better off are not wasted.

Exceptions: market failure, the individual pursuit of self-interest found in markets makes society worse off

→ the market outcome is inefficient.
When markets don’t achieve efficiency, government intervention can improve society’s welfare.

Why do markets fail?
Individual actions have *side effects* not taken into account by the market (externalities).

One party prevents mutually beneficial trades from occurring in the attempt to capture a greater share of resources for itself.

Some goods cannot be efficiently managed by markets.
   Ex.: Freeways in LA
Economy-Wide Interactions

Principles that underlie economy-wide interactions:

1. One person’s spending is another person’s income.

2. Overall spending sometimes gets out of line with the economy’s productive capacity.

3. Government policies can change spending.