INTERMEDIATE MICROECONOMICS LECTURE 1 – THINKING LIKE AN ECONOMIST

ECONOMICS can be defined as the study of how society allocates its scarce (limited) resources to satisfy unlimited wants.

We look at choices and try to estimate the expected benefits and costs, and we make decisions. We also try to understand the consequences of some actions, those consequences that are not so apparent in the first place. Think of some examples.

The Cost-Benefit Approach

- If the benefit of an activity exceeds its cost, do it.
- Reservation price of activity x: the price at which a person would be indifferent between doing x and not doing x. Another way to look at this is the price for an asset above which a buyer is not willing to pay and/or below which a seller is not will to take. This tension between the buyer wanting a low price and the seller wanting a high price helps create the market price for the asset.

Some Common Pitfalls for Decision Makers

Pitfall #1: Ignoring Implicit Costs

- If doing activity x means not being able to do activity y, then the value to you of doing y is an opportunity cost of doing x.

We all remember the concept of OPPORTUNITY COST - The next best forgone alternative or the cost of resources used to produce a product. In other words, the opportunity cost is the value of all that must be sacrificed to do the activity.

Pitfall #2: Failing to Ignore Sunk Costs

- An opportunity cost may not seem to be a relevant cost when in reality it is.
- On the other hand, sometimes an expenditure may seem relevant when in reality it is not.
  - Sunk costs: costs that are beyond recovery at the moment a decision is made.
  - These costs should be ignored.

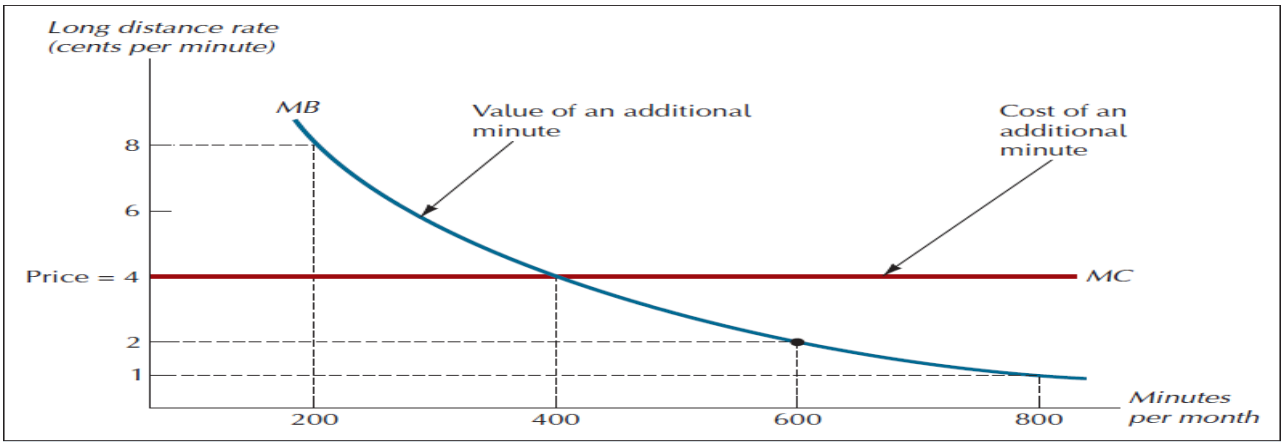
Pitfall #3: Measuring Costs and Benefits as Proportions Rather Than Absolute Dollar Amounts

- When comparing costs and benefits, always use absolute dollar amounts, not proportions.

Pitfall #4: Failure to Understand the Average-Marginal Distinction

- Compare the benefit and cost of an additional unit of activity.
  - Marginal cost: the increase in total cost that results from carrying out one additional unit of activity
  - Marginal benefit: the increase in total benefit that results from carrying out one additional unit of activity
- Keep increasing the level of an activity as long as its marginal benefit exceeds its marginal cost.

The Optimal Quality of Conversation



We will emphasize a model called the "**Perfectly Competitive Market Model.**" This model achieves "**allocative efficiency,**" that is, it allocates scarce resources in such a way that social welfare is maximized. We have to admit, however, that "social welfare" is very narrowly defined, and that the perfectly competitive market model does not assure equity in the distribution of goods and services.

This model is based on Adam Smith and the Invisible Hand.

- Everyone—consumers, firms, resource suppliers—attempts to get the most benefits for the least cost.
- As Adam Smith noted in 1776, self-interested individuals, wholly unaware of the effects of their actions, act as if driven by an *invisible hand* to produce the greatest social good.
- Laizze – faire: an economic doctrine that opposes governmental regulation of or interference in commerce beyond the minimum necessary for a free-enterprise system to operate according to its own economic laws.

POSITIVE AND NORMATIVE ECONOMICS

Positive Economics- Deals with objective or scientific explanations of the working of the economy. Emphasis here is on EXPLANATION with OBJECTIVITY.

Example: 'If a tax is imposed on a good, its price will tend to rise.'

Normative Economics - Offers prescriptions or recommendations based on personal value judgements. The emphasis here is more SUBJECTIVE, or what we think OUGHT to be.

Example: 'A tax SHOULD be imposed on tobacco to discourage smoking.'

We are going to develop some models of the "market" system. The market system operates fundamentally via prices to solve the questions what, how, and for whom in a context of scarcity.

HOMO ECONOMICUS

- The stereotypical decision maker in the self-interest model is given the label *Homo Economicus*, or "economic man"
- Homo Economicus only cares about personal material costs and benefits.
- Self-interest is one of the most important human motives, but it is not the only important motive.

THE ECONOMIC NATURALIST

An economic naturalist sees the mundane details of ordinary existence in a sharp new light—economics is around us everywhere.

CETERIS PARIBUS (assumption) - Translated from the Latin as all other things being equal or holding everything else constant.

Ceteris paribus example - "other things being equal". An analysis is conducted whereby one variable is changed while all other parameters are assumed stable.

For example, given the following functional relationship: $z = F(x_1, x_2, x_3, ..., x_n)$

Then the change in the dependent variable *z* given a change in the independent variable x_1 is: $\frac{\partial z}{\partial x_1} = \frac{\partial F}{\partial x_1} = F_1$ So if:

a. $F_1 < 0$, a Δx_1 has a negative impact on *z*.
b. $F_1 > 0$, a Δx_1 has a positive impact on *z*.

$\frac{\partial z}{\partial x_1}$ is the partial derivative of variable *z* with respect to x_1; it relates the change in *z* given a change in x_1, all other variables, i.e., $x_2, x_3 ....., x_n$, remaining stable, i.e., *ceteris paribus*.

Summary

- Microeconomics is concerned with the decisions made by small economic units.
- Microeconomics relies heavily on the use of theory and models.
- Microeconomics is concerned with positive questions and normative analysis.
- A *market* refers to a collection of buyers and sellers who interact and to the possibility for sales and purchases that results from that interaction.
- The market price is established by the interaction of buyers and sellers.
- A market's geographic boundaries and range of products must be defined.
- To eliminate the effects of inflation we measure real prices, rather than nominal prices.