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Lecture 1
Microeconomics

Introduction

- Economy : a system for co-ordinating society's productive activities

- Economics : social science that studies the production, distribution & consumption of goods & services

- Market Economy : an economy in which decisions about production & consumption are made by individual producers & consumers

Command Economy : Soviet Union 1917-1991

Mixed Economy : most are market-based with different degrees of government intervention

Adam Smith Invisible Hand : A market economy manages to harness the power of self-interset for the good of society

Microeconomics: the study of how individuals make decisions and how these decisions interact

But we knew even more the current crisis that invisible hand is <u>not</u> always our friend

Market Failure: individual pursuit of self-interest makes society worse-off

Examples of Market Failure: - traffic congestion (as much as $15 or more of hidden costs on other drivers)

- air & water pollution
- over exploitation of natural resources

Business Cycles: - the economy faces fluctuations — recessions, even depression

- Macroeconomics

Economic Growth :

- in the longer run, we are getting richer
- beginning of twentieth century only 10% of homes had flush toilet 2% had electricity

Chapter 1: First Principles

A. **Individual Choice:**

decision by an individual of what to do and what not to do

a. **resources are scarce**

resources: anything that can be used to produce something else

scarce: there is not enough of the resources available to satisfy all the various ways a society wants to use them

- limited income
- limited time
- limited quantity of human resources

- convenience stores charge higher prices than supermarkets but we may still go to convenience stores

- Individual choice up to individuals in a market economy
- some decisions up to local or even federal governments

6. Real cost: something you give up to get it

- opportunity cost
  the *next best* alternative that you give up

- Take History of Jazz vs Beginning Tennis

- opportunity cost is *not* alway additional to monetary cost - need to compare the alternatives

- may be the most important concept

c. "How much" is a Decision at the Margin

- study an extra hour of chemistry or an extra hour of economics
- marginal (extra) benefit and marginal (extra) cost
- trade-off, marginal analysis

d. People usually Exploit opportunities to Make themselves better Off

- If earning of MBAs ↑ while law ~~a~~degress ↓, more students go to MBAs
- Generally, people face incentives and they respond
- A plan to get manufacturers to reduce pollution voluntariy probably won't be effective, with financial incentives to reduce pollution, more likely

4 principles of individual choices

B. Interaction of Individual choices : my choices affect your choices, results can be different from what individuals intend

5 principles

a) there are gains from trade - individuals engage in trade; they provide goods & services to others and receive goods & services in return

- we specialize and trade; we all benefit

6. Markets move toward equilibrium

- previously closed cash registers open
- shoppers rush to the register
- the lines are equally long

- people act to make themselves better off
- a situation in which individuals cannot make themselves better off by doing something different — economists call equilibrium

- a useful concept because ~~be~~ sometimes the interactions can be quite complex
- you do not need to know how shoppers move, any time there is a change, the lines will be equally long - moving to equilibrium

c. Resources Should be Used as Efficiently as Possible to achieve Society's Goals

- an economy's resources are used efficiently when they are used in a way that has fully exploited all opportunities to make everyone better off

or <u>an economy is efficient</u>
if it takes all opportunities
to make some people
better off without making
other people worse off

e.g. we are crammed into
a small classroom, but
a large classroom nearby
is unused, we can make
ourselves better off without
hurting others – this is
economically inefficient

if all large classrooms are in use, we can only make ourselves better off by hurting others – displacing them & make them use a smaller classroom

when an economy is efficient, it is getting the maximum output, given its resources, possibilities for trade

should we strive to achieve economic efficiency? other issues : <u>equity</u>

there is a trade-off
between equity and efficiency
in many cases
e.g. disabled-designated
parking spaces

- there may be many cases
of empty disabled-designated
parking spaces
- a conflict between equity,
making life fairer for
disabled people and efficiency,
making sure that people fully
exploit all opportunities to make
people themselves better off

How far policymakers should go in promoting equity over efficiency – the heart of the political process

- U.S. vs Europe vs. Japan

d. Markets usually lead to Efficiency

- Markets allow people to fully exploit their opportunities
- Incentives built into a market ensure ~~that~~ resources are put to good use
- but we have <u>market failures</u>

e.) When markets do not achieve efficiency, government intervention can improve society's welfare

3 principal ways that markets fail

i) individual actions have side effects — pollution e.g.

ii) One party prevents mutually beneficial trades from occurring in an attempt to capture a greater share of resources for itself
e.g. a drug company keeps useful drug prices too high

iii) Some goods / services by
their nature are unsuited
for efficient management
by the markets

- it is important to learn
to identify when markets
work and when they do
not