

Why study microeconomics?

What is economics?

Alfred Marshall – “Economics is the study of man in the everyday business of life”

Economics – the study of how individuals make decisions in the presence of scarcity

Important concepts of economics:

Scarcity – resources are limited; in choosing one thing we can't do another. A feature of all situations of policy interest. Otherwise do everything would be the best policy. Instead we must choose the best course of action. The cost of choosing one policy is the other policies which could not implement instead (opportunity cost, see below).

Rationality –

Definition/Assumptions of rationality

1. Individuals act in self interest. Self interest is by definition whatever is in the interest of the individual involved. He/she acts to further what they care about. But note that the individual may care about other people so self-interest in an economic sense isn't necessarily the same as selfishness in the traditional sense.
2. Individuals try to achieve self interest in most systematic way possible (they behave like mathematical optimizers).

Why should we (NOT) study economics?

Why yes: *Positive vs. Normative economics*

Positive economics is engaged in describing the world, describing how people actually behave. Normative economics describes how the world should be or people should behave. For the first, to argue NOT, claim economics does not describe individual behavior (because assumptions are wrong – or perhaps not, see below). But then we could still say that people *should* (ought to) behave rationally. Aristotle: tragedy describes the world the way it ought to be (like normative economics); history describes the world the way it is (like positive economics).

Why not: The assumptions are wrong (rationality and scarcity)

Why not: The assumption of rationality is wrong. We know that individuals are not rational. They behave for emotional, psychological, and intuitive reasons.

Why yes:

1. Economics is concerned with describing or predicting *behavior*, not how people justify their behavior (or the self-conscious motivations). Milton Friedman – just like a billiard ball doesn't understand the differential equations that describe its motion, economics may describe human behavior without describing the introspective process that leads to that behavior.
2. Predicting individual behavior is difficult, but the behavior of groups (market behavior) may be easier to describe/predict
3. Evolutionary biology predicts human behavior – people want to “maximize” their survival and will act in a systematic way to protect their survival.

Why not: The assumption of scarcity is wrong

Why yes: Scarcity may not be the primitive aspect of human behavior, but could be construct of the market itself (advertising).

Why not: There may be more important things to study:

However, Efficiency (objective of economics) and equity (non-economic objectives) may not be mutually exclusive. May need a bigger “pie” to achieve non-economic objectives.

Presuppositions of economics (basic concepts to which most economists would agree)

1. *Nominal vs. Real vs. Relative price*. Price is defined or has meaning only as a relative concept. The price of coffee is \$1 means only that in buying that coffee you give up two 50 cent cookies, three 25 cent apples, etc. (i.e. relative prices). Prices are measured in dollars, but that is only a unit of account or a way to measure the price. But as we will see the value of this unit of account changes over time. One dollar in 1983 is not equal to one dollar in 2000, because the general price level has changed (aside from any change in relative prices). Most often we dollar amounts denominated in nominal dollars (i.e., from the year in which the amount is measured). But when comparing dollar values across time we must control for the fact that the price level has changed. We convert nominal dollars (from various years) into one common unit of measure (real or constant dollars in some reference year).
2. *Opportunity cost* – cost of undertaking an action must be compared with the other possible action/option that could have been taken
Example: the cost of a SIPA education must be compared to the cost of a salary that you could have been earned, which is the alternative use of your time Even if you own a business, the value of your time has an opportunity cost (some other job), if not an accounting cost (you don't write a check to yourself).

3. Agents think strategically and continually reoptimize. When you change the policy framework you must assume that agents will recompute their best course of action in the new policy environment.

Example: “3 strikes and you’re out” parole. Legislators assumed the plea bargain behavior would remain constant. Instead after the new law, those who were charged hesitated to accept a plea bargain (since after three convictions, no more parole), backing up the legal system.

Example: Tax free week in New York: won’t necessarily increase sales of clothes (though it might), but many people will just change the timing of their purchases to coincide with tax free week.

4. Value of information – economics models and considers the value of a piece of information that one person has

Asymmetric information – when one individual has information that another does not have. Will be used to explain insurance and wage contracts later in the term.

5. Analysis of thinking of general economic equilibrium – understand the repercussions of one market in other markets (e.g. minimum wage, may have impacts on individual decisions of education). Gasoline prices may influence automobile purchase decisions.
6. Incentives and individual rationality – people act and speak in their self interest (e.g., policeman’s union in Boston speaks in favor of keeping “flag men” - trained police officers who direct traffic at construction sites). Does not invalidate what people say, but economists should be aware of possible biases people have in speaking in their own interest. That’s the job of the policy analyst: to keep a balance perspective.
7. Demand and supply: very useful tool. We will study it next.