Lecture # 1 -- What is Microeconomics?

I. What is Microeconomics?

- The main goal of this course is to introduce you to the application of the principles of microeconomic analysis to policy questions.
- Economics is the study of the allocation of scarce resources.
  - Economics is a theory of how markets can be used to allocate scarce resources.
  - However, note that markets are not the only way to allocate scarce resources (e.g. command economy).
    - The article on health care emphasizes that such decisions need to made, either by the market or by other means.
      - For example, a government board may decide which treatments make the best use of limited resource.
        - Note that even there, costs are an issue.
- Microeconomics studies the interaction among individual economic units.
- Key questions:
  - How to utilize resources most efficiently.
    - What to produce?
    - How to produce it?
      - E.g. how much capital and how much labor
  - How to allocate the goods and services that are produced.
    - In a market economy, goods and services are allocated based on ability to pay.
- Goals for the course:
  - Develop a theory of the market
    - We'll discuss how the market addresses the above questions.
    - We'll consider how the incentives provided by the market affect behavior.
    - We'll also consider how interventions into the marketplace affect those incentives and change outcomes.
  - Look at what happens when the market breaks down (e.g. monopoly, pollution, etc.)
  - Ask what role the government can play in the market.
- The example on CEO salaries illustrates why theory is important
  - Possible remedies depend on the reasons why CEO salaries are high.
  - For advocates who want to address high CEO salaries, is the justification correcting a market failure, or simply about improving equity?

II. A Word About Theory

- Our goal is to explain the world around us and to make predictions.
- Economists use theories and models to do this.
- Model – a mathematical representation, based on theory, of a firm, market or some other economic activity. It describes the relationship between two or more economic variables.
    - Key is to model relevant features, not every detail.
    - Although these theories and models may seem simple, the goal is to focus on only the aspects of the problem that are relevant (remember the model plane example).
- Finally, theories can be tested by doing empirical work.
    - Looking at actual data
    - Need theory to know what to look for
    - Theory leads to predictions that can be tested.

III. Positive versus Normative Economics

- Positive economics -- studies how the economy actually functions.
- Normative economics -- the study of whether or not the economy produces socially desirable results.

IV. Key Concepts in Economics

- We finished class today with a discussion of some of the most important concepts in economics. These are concepts that we will come back to throughout the year, as they are fundamental to the way economists think. I introduce them now to highlight their importance.
- Marginal analysis
    - Economists focus on things at the margin – that is, what is the benefit of the next good that is bought or sold.
    - Once you have purchased something, what matters is what you will do next. Can you make yourself any better?
    - Our goal is to maximize total net benefit: the value of the good minus the cost.
        - To do this, we focus on the marginal benefits and marginal costs.
            - If MB > MC, total benefit will increase. You should purchase.
            - If MC > MB, total benefit will decrease. Do not purchase.
            - The only time that total benefit will not rise or fall is when MB = MC.
                - This is where total net benefit is maximized.
- Sunk costs
    - <u>Sunk costs</u> are expenditures that have been made and cannot be recovered.
    - Following from marginal analysis, sunk costs should be ignored.
        - Since sunk costs cannot be changed, they should not influence decision-making.
- Opportunity costs
    - <u>Opportunity cost</u> is the value of the best alternative use of a resource.
        - It is the cost of forgone opportunities.
    - For MPA students, could have been working and earning a salary. The opportunity cost of going to Maxwell is tuition plus the salary you forgo by not working.
    - Opportunity costs are important to consider, but often ignored.
    - Opportunity costs relate to the key concept of scarcity. Once a resource has been used, it cannot be used for something else.