

MICROECONOMICS:
A REALLY FAST INTRODUCTION

ECON 130(3)
University of Hawai`i-Mānoa
August 24-26, 2009
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Economy. . .

- The word *economy* comes from a Greek word for “one who manages a household.”
- Management implies decisions.
- Economics is about **choice and decisions**.
- There are different levels of decisions and different types of people who make decisions.
 - Individuals make decisions.
 - Households make decisions.
 - Managers and firms make decisions.
 - Bureaucrats and governments make decisions.

SEVEN PRINCIPLES OF
MICROECONOMICS

The Mankiw textbook has TEN Principles but # 8, 9 and 10 are Principles of Macroeconomics (so I'll skip them—you can read about them).

Principle #1: People Face Tradeoffs.

“There is no such thing as a free lunch!”



Principle #1: People Face Tradeoffs.

In Waikiki, you can get an invitation to a free lunch where a speaker will “inform” you about time share condominiums and then tell exactly

WHY YOU MUST PURCHASE ONE NOW!!!
BEFORE YOU LEAVE THE ROOM!!!

Is that lunch really free?

Principle #1: People Face Tradeoffs.

Tradeoffs are everywhere:

- Policymaker: armor for soldiers in Iraq v. dialysis for kidney disease patients v. drug rehab for addicts.
- Student: watching an NFL playoff game v. reading chapter in this class's textbook.
- Bill Gates: leisure time v. work time.

Making decisions requires trading off one goal against another.

Principle #1: People Face Tradeoffs

- Efficiency v. Equity
 - *Efficiency* means society gets the most that it can from its scarce resources.
 - *Equity* means the benefits from those scarce resources are distributed fairly among the members of society.

Principle #2: The Cost of An Action is the Highest Valued Opportunity Foregone.

- Decisions require comparison of costs and benefits of alternatives.
 - Whether to go to college or to work?
 - Whether to study or go out on a date?
 - Whether to go to class or sleep in?
- The *opportunity cost* of a decision is the value of the highest valued opportunity that you give up when you choose one option.

Principle #2: The Cost of An Action is the Highest Valued Opportunity Foregone.

- Cost of attending college fulltime for a year?
 - Housing in the dorm?
 - Meal plan?
 - Books?
 - Tuition?
 - Time spent in class, studying, and in finals?
- Cost of watching an hour of CNN?
- Cost of attending the first Econ 130(4) class?

Principle #2: The Cost of an Action is the Highest Valued Opportunity Foregone.



- The cost of choosing leisure over study in college is often millions of dollars.
- The cost of going to a concert in New York is higher than in Honolulu because it is more likely that you are giving up another extraordinary concert than in Honolulu.

Principle #3: Rational People Think at the Margin.

- *Marginal changes* are small, incremental adjustments to an existing plan of action.

People make decisions by comparing costs and benefits at THE MARGIN.

Principle #3: Rational People Think at the Margin.

- **How long should you study materials Econ 130(3) this week?**
 - Note: First problem set is due on Thursday, August 27, 2009 at 9 pm.
 - Marginal cost (MC) of first hour.
 - Marginal benefit (MB) of first hour.
 - Continue until $MC = MB$ iff total benefits of activity (TB) > total costs of activity (TC).

Principle #4: People Respond to Incentives.

- Marginal changes in costs or benefits motivate a person to respond to maximize their net benefits.
- If you have two choices (A and B), then the cost of choosing A is the lost **net** benefits from B, while the cost of choosing B is the lost **net** benefits from A.
- Add one more day to the Vancouver 2010 Winter Olympics? Why 14 days? Why not 15? Or 365? Or the rest of your life?

Principle #5: Trade Can Make Everyone Better Off.

- People gain from their ability to trade with one another.
- Competition results in gains from trading.
- Trade allows people to specialize in what they do best.
- Assumptions
 - Both parties are rational.
 - Both parties are well informed.
 - Benefits and costs do not spillover to other people.

Principle #6: Markets Are Usually a Good Way to Organize Economic Activity.

- A **market economy** is an economy that allocates resources through the decentralized decisions of many firms and households as they interact in markets.
 - Households decide what to buy and for whom and how much to work.
 - Firms decide who to hire and what to produce.
 - Government provides a framework of property rights and contract rights to facilitate well-functioning markets.

Principle #6: Markets Are Usually a Good Way to Organize Economic Activity.

- Adam Smith—an 18th century economist - philosopher—made the observation that households and firms interacting in markets act as if guided by an “invisible hand.”
 - Because households and firms look at prices when deciding what to buy and sell, they unknowingly take into account the social costs of their actions.
 - As a result, prices guide decision makers to reach outcomes that tend to maximize the welfare of society as a whole.

Principle #7: Governments Can Sometimes Improve Market Outcomes.

- Market failure may be caused by
 - an **externality**, which occurs when trade or production produces costs or benefits for third parties not participating in the trade or production.
 - **market power**, which is the ability of a single person or firm to affect market prices by altering the quantities that they buy or sell on the market.
 - Lack of **property rights** in the traded goods.

Principle #7: Governments Can Sometimes Improve Market Outcomes.

- When the market fails--breaks down, then government can **sometimes** effectively intervene to promote efficiency and/or equity.
- If property rights are well defined and not too many individuals are involved, then negotiations may resolve the market failure in some cases.
- In other cases—provision of “public goods”—government intervention is typically required.

Summary

- When individuals make decisions, they face tradeoffs among alternative goals.
- The cost of any action is measured in terms of foregone opportunities.
- Rational people make decisions by comparing marginal costs and marginal benefits.
- People change their behavior in response to the incentives they face.

Summary

- Trade can be mutually beneficial.
- Markets are usually a good way of coordinating trade among people.
- Government can potentially improve market outcomes if there is some market failure or if the market outcome is inequitable.
- **FIRST PROBLEM SET IS DUE AT 9 pm ON THURSDAY, August 27, 2009.**