

MICROECONOMICS I.

"B"

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week 1

The nature and scope of economics, part 1

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The course was prepared by Gergely Kőhegyi, using *Jack Hirshleifer, Amihai Glazer and David Hirshleifer (2009) Mikroökonómia. Budapest: Osiris Kiadó, ELTECON-books (henceforth HGH)*, and *Gábor Kertesi (ed.) (2004) Mikroökonómia előadásvázlatok. <http://econ.core.hu/kertesi/kertesimikro/> (henceforth KG)*.

The nature and scope of economics

Economics has several schools. BUT this course will only deal with its *main stream*, the neoclassical line of thinking.

Subject of economics

What is economics?

- Science
 - Goal:
 - * to *explain* things that have already happened.
 - * to *forecast* things that have not yet happened.
 - The "What is science" question is very hard to answer. The philosophy of science deals with such questions. And WE DO NOT!
- Social science
 - Deals with human behavior and human interaction
 - According to standard classification social sciences are: Sociology, Economics, Anthropology, Political Science, Psychology
 - Middling cases: (Human)ethology, Physiology, (Socio)biology, (Neuro)psychology?
 - In reality, it is very hard to say what social science is, to classify a science based only on its subject.
 - * The subject of economics is wealth or welfare, or decisions, or well-being, or income distribution, or ...?
- Its a way of thinking or to put it differently: a METHOD to study the phenomena around us, using only a handful of principles
 - This way we do not bind ourselves, which makes our life easier
 - This could include, for instance, the study of animal behavior ...
 - We follow this approach here!!!

Types of economic questions in a narrower sense:

- Should the CEO of a company invest in a new assembly line, and thus increase production capacity, or equip a new laboratory to develop a new product? (how will s/he decide?)
- If someone inherits a larger sum of money, should s/he buy stocks, or buy some property instead? (how will s/he decide?)
- Should a local government build a new school or a new pensioners home? (how will it decide?)
- Should the government finance road construction or higher education? (how will it decide?)
- Should I take the job at a multinational company or start my own business? (how will I decide?)

Types of economic questions in a broader sense:

- Should I become a doctor, an engineer, a lawyer or an economist? (how will I decide?)
- How long should I search until I find my key? (how will I decide?)
- Who should I marry? (how will I decide?)
- Should I go for a beer or study for the next day economics exam? (how will I decide?)
- Should I buy a ticket or balk the fare? (how will I decide?)
- Should I buy the microeconomics book or try to loan it from the library? (how will I decide?)
- Why does the cat catches the fatter mouse?

What were the common things in all of the answers above?

- We have compared the benefits and the costs (in a broader sense).

Note 1. *We will try to follow this approach in general: economics is a social science, which tries to come up with general hypotheses and regularities for the members of the society, unlike e.g. some subdisciplines of anthropology.*

- we are talking about *scarce resources*

Note 2. *If there is no scarcity, there is nothing to decide about. A problem becomes an economic problem if SCARCITY holds.*

- Scarcity will make people to decide!

Note 3. *People can decide in many ways: e.g. randomly, submitting ourselves to a higher force, by the "oracle method" ...*

- But we assume rational decision making

Assumption 1. *Rationality postulate (for now) intuitively: economic actors will look at costs and benefits and within their set of options will choose the best(s)*

- When making a decision, we also have to take different possibilities into account. Among these alternative possibilities we have to look at the one with the highest *opportunity cost*
- Every time we neglect some (not necessarily unimportant) factors (which ones?), while emphasizing others: we make MODELS!
- We build models based on our assumptions (e.g. scarcity, rationality, costs-benefit analysis), and draw conclusions using these models

Note 4. *The economic view of the human being, the HOMO OECONOMICUS (a rational man following his best economic interest) is a simplification as well. This however provides a well functioning tool to explain certain phenomena, but no-one thinks that people are only like this.*

Note 5. *A model necessarily contains some unrealistic elements. But how could we use a map that is a perfect copy of reality?*

Fundamental notions of economics

"Economic man"

Is the Homo Oeconomicus a useful model? Are people rational?

E.g.: (HGH example 1.3) rational drivers
TWO-CAR ACCIDENTS WITH/WITHOUT AIRBAGS
(VIRGINIA, 1993)

	With airbags	Without airbags
Number of cars	30 (50 percent)	30 (50 percent)
Number of "initiators"	22 (73 percent)	8 (27 percent)

Adapted from Peterson et al., p. 262.

E.g.: (HGH example 1.4) Rational malingering

- What are the goals of self-interest?

Assumption 2. *The goals of the Homo Oeconomicus stem from some sort of a taste.*

- Individual goals, norms and tastes can differ extensively.
 - culture (eating beef + child protection versus protecting cattle + infanticide (HGH 1.2)
 - subculture (Who would cut the throat of a chicken?)
 - individuals (Who likes spinach?)
- Individual goals, norms and tastes could be unstable.
 - "People change . . . "
 - Advertisements, political campaigns..., etc.

Assumption 3. *We assume that the Homo Oeconomicus has a stable preference ordering.*

Note 6. *Benevolence, malignancy, altruism, etc. can be a part of the preferences. How?*

Note 7. *Rationality \neq Omniscience. But rational decision is possible in situations with no perfect or uncertain information.*

Allocation of goods and resources

Allocation mechanisms

(HGH1.3) If we want bread from the baker, then

- we work, and with the money earned we can buy the bread.
- we steal the bread.
- we try to convince the baker to have some mercy and give us some bread.
- we can organize a political movement with the goal of forcing the bakers to hand over the bread
- etc.

Can delinquency, the ways of the soul, or politics (non market mechanisms) be the subject of economic analysis?

- E.g.: Draconian punishment of the habitual criminals (HGH example 1.8)

- E.g.: Is it worth to be a psychiatric patient? (HGH)
- E.g.: Why governments do not like to pursue great (e.g. health care, tax, pension, etc.) reforms?

E.g.: (HGH 1.4) Consider the allocation of seats in your classroom. Some seats are more desirable than others. The possible rules of allocation are:

- first come first served. (non market)
- the professor assign the seats on any basis (non market)
- the students might elect a committee to assign the seats (non market)
- it can depend on our ability to jostle and trample on others (non market)
- auction (market)

Example: (HGH 1.9) Bidding for faculty offices at the Arizona State University

- Management Department: based on seniority (non market)
- Finance Department: first come first served (non market)
- Statistics Department: randomly (throwing the dice) (non market)
- Economics Department: auction (market)

Example.: (Károly Polányi) Allocation of goods and resources in different societies ("coordination mechanisms"):

- redistribution (non market)
- reciprocity (non market)
- exchange of goods (market)

Market interactions

Characteristics of market interactions

- reciprocity and free-will
- the most important information is transmitted by price

Definition 1. *The price is the term on which goods or resources are exchanged.*

- The buyers must be willing to pay the market price in order to get the given product, while those can sell the product, who are willing to give it up for the same price.
- From the consumers side: those will get the goods, who pay the most.
- From the sellers side: prices will define production.
- As soon as the price exceeds the costs of production, it becomes profitable to produce more. Not only those on the market will produce more, but other will also be inclined to enter the market.

Are market transactions really voluntary?

- Can a poor man refuse a job offer, which pays very badly, but at least s/he could buy bread from the money earned. Is it not "wage-slavery"?
- Or take a bandit threatening his victim: "Money or life?" Is it a voluntary exchange?
- How could we differentiate the bandits coercive action with the market exchange?

Statement 1. *The key (for now) intuitively is to clarify the rights and "rules of the game" (legal framework, norms, etc.)*

Economics and social science

Pursuing self interest

Intended and unintended consequences of decisions

Decisions have intended and unintended consequences which can affect other decision makers as well.

- If I buy a bread and eat it, then the intended consequence of this decision is that I will not be hungry any more. But an unintended consequence will be that the baker will have money to buy clothes, or that I increase the GDP of the country, I help to boost the economy of the country and thus indirectly I help the poor; however I have only followed my own interest.
- If everyone seeks their own self interest in a hypermarket they will stand in the shortest line. If we know this, then we do not have to search for the shortest line (and walk from one side of the building to the other), because we can trust that lines there will be just as long as they are around us. So, although everyone was following self interest, everyone else profited from this.
- We want to buy a sandwich at the lake Balaton at the lake shore. There are many bars and many people. Is it worth to look at the price of the sandwich at each bar to find the cheapest?

What was the common in the arguments above?

- We have used the principle of *methodological individualism*: we trace back social behavior (how lines form in hypermarkets, how sandwich prices are set, etc.) to individual behavior.

Note 8. *This principle is used widely in economics, and also in other social sciences.*

- Following self interest produced an advantageous state for the whole society (the principle of "*the invisible hand*")

System of incentives

Market failures

Pursuing self interest is not always beneficial for the society

- If it is worth bilking on the bus, because the ticket is very pricey, the penalty is not very high and there are few controllers, what will happen?
- Why do the Austrian leather preparing company pollute the Rába? Who will pay the costs, and who gets the benefits?
- Why do the drivers of the long distance coaches sell tickets under the official price (without a receipt)? What are the consequences of this action?

So for example if

- many people consumes a product not only one
- the actors have more impact on each other than in a simple exchange (external effects)
- the informational structure is special (informational asymmetry)

Note 9. *To clarify the rights and "rules of the game" (legal framework, norms, etc.) help in these cases (market failures) as well.*

Note 10. *Unfortunately, this can not always be done perfectly, or would cost too much*

Why can economies never be perfectly "bleached"? But economic actors react to *incentives*, which can be modified case-by-case.

- What makes the bilker not to buy a ticket?

- And the bus driver to cheat?
- And the criminal to steal?
- And the BKV not to waste resources?
- And the governments to do good economic policy?
- And the companies to produce/raise prices?
- And the consumer to buy from credit?

How can these be modified so that societal costs are lower? And what are the costs of these? What other types of incentives can be created?

- e.g.: King Solomon and the child cut in half.

Note 11. *The MARKET MECHANISM is a sort of incentive system (which needs very few information and is cost-effective).*

Positive versus Normative analysis

"IS" versus "OUGHT"

- Not all incentive system allocates goods and resources the same way.
- "Market mechanism is not just, it favors the rich. So this *should not* dominate"
- What does "just" mean?
 - Equal distribution?
 - Distribution by effort?
 - Distribution by needs?
 - etc.
- This is a hard philosophical dilemma, with no consensus around it. We *do not* deal with this question.
- We will follow a positive line of analysis.

Does it matter whether we use positive or normative approach when considering the following statements? Do not mix the two approaches!

- Smoking should be banned in closed public places.
- If smoking would be banned in open places, the demand for cigarettes would decrease.
- The tobacco industry would oppose a law that limits the places where smoking is allowed.
- The right of non-smokers for fresh air is more important than the right of smokers to pollute the air.
- The anti-smoking law would not have any effect on the quantity of cigarettes sold, because smokers would smoke just as many times but they would use the places where it is allowed.