

Microeconomics

August 24, 2011

WORKSHEET 1 AVAILABLE AFTER CLASS TODAY

Homework 1 available after class Friday

Economics

Economics is the study of how people make decisions when faced with scarcity:

- What to produce?
- Which combination of factors of production should be used in production?- (IE. Tractors and fertilizers vs. tons of people)
- Who, if anybody, should allocate what is produced?
A group of people? Markets?...

Economics is a social science

Deals with actions and interactions of people

The Scientific Method:

- Question
- Define hypothesis
- Test hypothesis
 - Controlled vs. natural experiments
 - Causation vs. correlation
- Revise original hypothesis
- Hypothesis that resist data testing become part of theories

Economic Modes

Abstract representation of the real world, a collection of rules

- Difficult
- Behavioral economics: combine psychology, economic theories and other tools to model our behavior

Goal: make good predictions

- Not to describe the world in detail

Role of simplifying assumptions:

- Focus on the important relationships
- Avoid unnecessary details

Generalizations

- The consumer theory applies to a "regular consumer"

Other-things-equal assumption "ceteris paribus"

- Allows to focus on one event only

Graphical expression

Unlimited wants... and limited resources (money, time, etc).. force us to make CHOICES

Each choice has an opportunity cost (there is no "free lunch")

- Important correctly measure opportunity costs
- Value of next BEST opportunity

Example

Moving to another state to get a better paying job

You currently earn \$40,000 in Missouri

Value of doing nothing: \$38,000

Opportunity cost of moving?

\$40,000

\$78,000- cannot add these together, it's either one or the other

so this is

wrong

Cost Benefit Analysis

How people make choices

Important for producers/governments (taxes)

Assumption: individuals are rational (consistent)

Decision making process goal: make yourself as happy as possible = maximize your economic surplus

Pro-con lists are similar representations of a cost-benefit analysis

Lists are different for every person (pro/cons considerations)

List is based on your expectations

If expectations are bad, you might make a bad decision (still rational)

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Cost Benefit Analysis

- Pro-con lists are similar representations of a cost-benefit analysis
 - Lists are different for every person
 - List is based on your expectations
 - If expectations are bad, you might make a bad decision (still rational)
 - Decision can change due to incentives.

Pro/Con List

Pros (out of state school)	Cons (out of state school)
Better weather	Higher travel expenses
More leisure opportunities	Less chance to be with friends and family
Chance to live in a new part of the country	Higher cost of living

Cost/Benefit Analysis

Expected Benefits (out of state school)	Expected Cost (out of state school)
Weather \$2,000	Travel \$5,800
Leisure \$3,000	Family and friends \$1,500
Geography \$1,000	Cost of Living \$3,200
Total expected Costs \$6,000	Total Expected Cost= \$10,500

*Expectations will change depending on the person and what the expectations mean to them. (Expected Costs for the out of state school will outweigh the expected benefits for the in state school. Therefore it is irrational to go to the out of state school.)

Cost Benefit Analysis

- Assumption; people make decision "at the margin"
 - Expected marginal economic surplus= expected marginal benefit-expected marginal cost.
- Ignore sunk cost (not to be considered in the cost-benefit analysis because in any event you cannot recover the sunk cost.)

Sunk Costs

- You pay for a nonrefundable plane ticket and reconsider your decision later
- You pay for a movie ticket and decide to stay or leave after the movie started.
- Buy a share of stock and its price changes not according to your expectations.

Conclusion

- You made a bad decision (based on bad information/expectations)
- Your decision was rational (increased your economic surplus)

Market Failure – Externalities

- Market failure due to imperfect information. Solutions:
 - Production of information (health, financial, transactions, etc.)