1 Basics

ECO202 Spring 2019

January 29, 2019

Outline

1. What is Microeconomics?
2. Prices
3. Theory and Models

What is Microeconomics?

Micro means small units

Small units:

- Individual consumers
- Workers
- Firms
- Firms in single markets

All these units need to make **decisions**

Decisions involve trade-offs

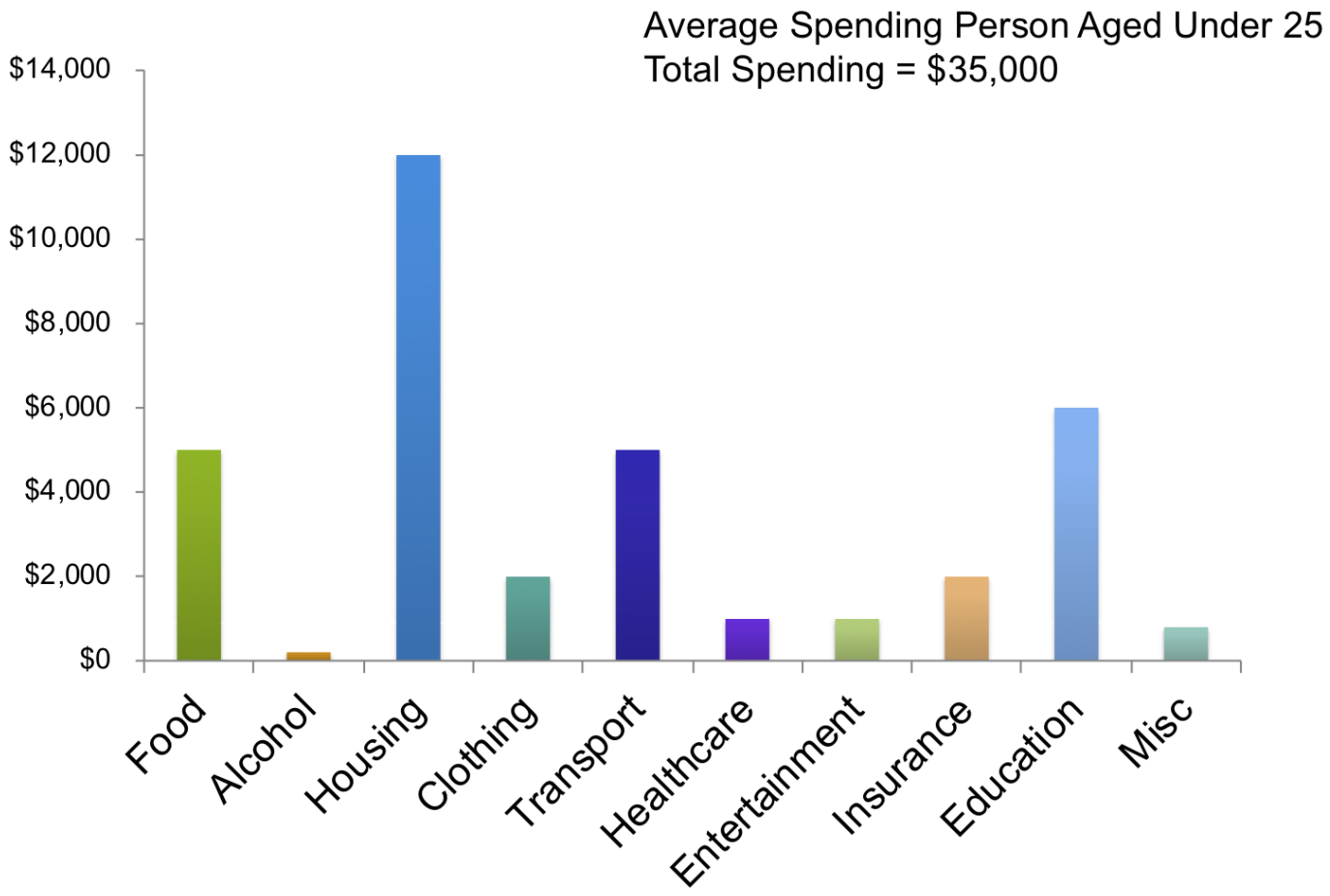
Trade-offs:

- Individual consumers: buy pizza, not pasta
- Workers: pull extra shift, not sleep-in
- Firms: hire labor, not robots
- Firms in single markets: compete, not collude

Constrained by income, time, budget, other firms

Every decision is a **constrained optimization**

Your spending patterns



Prices

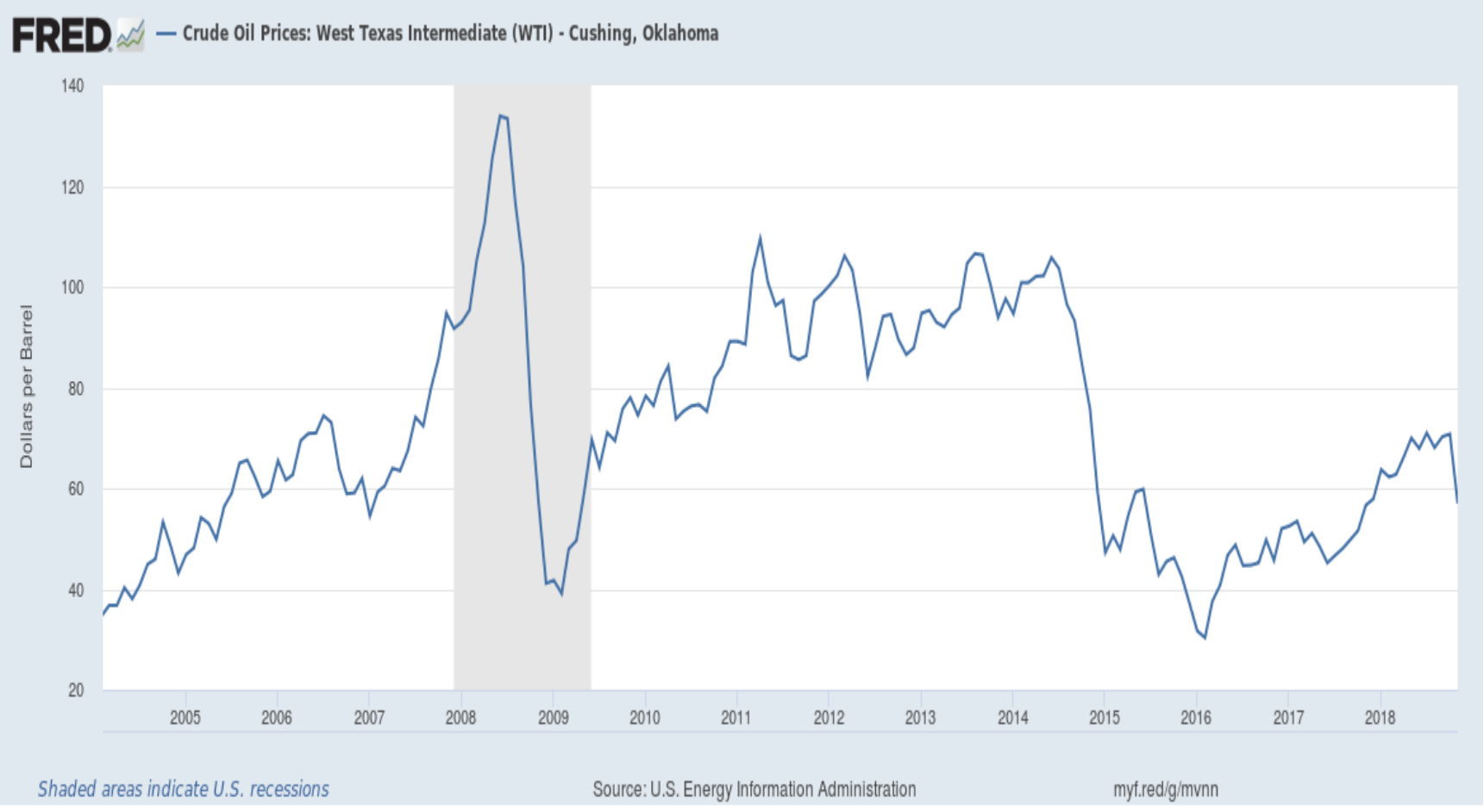
Prices are determined in markets

- **Supply function:** decisions of firms about how much to produce given expected market price
- **Demand function:** decisions of consumers about how much to buy given expected market price

Equilibrium of **S**=**D** determines market price **P**

Need to understand how firms and consumers decide

Crude oil prices fluctuate a lot



Prices are signals

Price of oil tells:

- Consumers what they have to give up to get oil
- Producers how much profit they will make if they sell oil
- Producers of substitute energy sources how much profit they might make

Higher prices = bigger effect?

If you want better quality, should you just pay more?

Factors influencing effort to do task (=quality):

- Money \$
- Enjoyment E
- Image I

If \$ or E or I go up, effort should go up

Paying more may not yield higher quality

Increasing \$ may reduce E or I

Offering extra \$ may signal negatively to worker:

- Job is terrible or not valued (E falls)
- They are not trusted (I falls)
- They are 'just in it for money' (I falls)

If you want a high quality date:

- Buy them flowers? (their E and I rise)
- Pay them? ($\Delta\mathrm{E}<0$, $\Delta\mathrm{I}<0$)

How to increase quality=effort

Avoid paying extra when \$ reduces (or only weakly increases) quality

Understand the importance of image I:

- Home energy saving $(\mathrm{I}{=}0)$
- Buying a hybrid car $(\mathrm{I}{=}?)$
- Paying too little $(\Delta\mathrm{I}{<}0)$

Should schools pay students to study?

Studies show that big enough incentives for school students:

- Can increase attendance
- Do not boost effort or grades
- Have negative effects when removed (\$ gone, E and I do not go back up)

Why does \$ work for attendance?

Why does $ work for school attendance?

- **Opportunity cost:** Many poor students would otherwise have to work
- **Contract success:** Attendance is a verifiable task students know how to do
- **Risk aversion:** Students might be uncertain what the grade-$ relationship is

Are prices important?

In most situations: **Pay! $! Price matters!**

Money payments can be:

- Big
- Varied a lot
- Flexible

But:

- Discontinuity: 'Pay enough or don't pay at all'
- $ can offset E and I

Theory and Models

Theories are stories

- They are ways of explaining and predicting observed phenomena
- They are based on assumptions and rules

Good theories accurately **explain** and **predict** important economic outcomes

Models are theories in math

- They are deliberately simple
- Models are combinations of functions

$$S_x = f(P_x, w_{skilled}, w_{unskilled}, r_{robot})$$
$$D_x = f(P_x, P_{subx}, P_{compx}, M)$$

- Put correct arguments in each function
- Arguments need accurate parameter values

Theories and models are amoral

- They are not evaluated based on niceness
- Theories and models are evaluated based on how well they predict and explain
- **Positivism:** what the world actually looks like; how it actually works
- Normative economics: how the world should be (Are prices *just*? Is *usury* allowable?)

Any Questions?

What is Microeconomics?

Prices

Theory and Models