Lecture 1 – Introduction to Microeconomics

I. Some Key Ideas

A. What is Economics?

Economics is the study of how society allocates scarce resources

Because there are not unlimited resources, there are always trade-offs. Resources that are devoted to one activity cannot be devoted to another.

B. Opportunity Cost

When there are trade-offs, it is important to get the true cost allocating resources in a certain way.

Example 1 – If a certain amount of capital and labor devoted to producing five shirts, could be used in another firm to produce 20 pounds of meat, the opportunity cost of producing the five shirts is 20 pounds of meat.

Example 2 – A student that comes to school for a semester spends $3000 in tuition and must work part-time (300 hours) instead of full-time (600 hours). Her wage is $15/hour. The opportunity cost of attending school includes the direct cost of $3,000 PLUS the lost wages of $4,500 for a total of $7,500.

C. Marginal Calculations

One of the important ideas you will take away from this class is the importance of thinking on the margin. Each trade-off involves allocation of the LAST units of a resource, not the total. This is thinking on the margin.

D. Incentives

Economic actors respond to incentives.

E. Importance of Markets

If we can understand how markets work, we can understand how much will be bought and sold and what the price will be.

Markets are a very good way to let economic actors determine how resources will be allocated in most circumstances. Usually, it is a good idea for the government to let markets function without intervening.

There are some situations (externalities, common resources, public goods, monopoly, imperfect information) in which the market does not do a good job. In these situations, the government should get involved.

F. Positive Versus Normative Economics

Positive = Descriptive

Normative = What should happen
II. How Economists Think -- Theories

Constructing a Theory – Taking a complicated world and trying to make some sense of it by:

1) Understanding the relationships between things that exist
2) Isolating the relationships that are important

If the theory is a good representation of the most important aspects of the real world, we may be able to use it to make predictions:

1) Predictions of what will happen because of events outside of our control
2) Predictions of what will happen because of events that are within our control (policy)

How do we do this?

1) Observe the real world
2) Get an idea that is the first version of the theory. Formulate the assumptions of the theory and the predictions of the theory.
3) Observe the real world some more
4) Figure out what parts of the real world the theory explains well and what parts it does not explain well
5) Either:
   -- Toss out the theory because it does not do a very good job explaining the real world
   -- Modify the theory to take into account the things that were not explained well in the previous version
6) Repeat steps 3, 4, and 5
III. First Model – Simple Economy

1 Firm and 1 Household

Assume:
The firm hires the members of the household to work for the firm (Market for Labor)
The household buys goods from the firm (Market for Goods)

We can represent this in a circular-flow diagram

A -- The Firm sells goods in the market for goods and receives revenue for those goods
B – The Household buys goods in the market for goods and spends money to get them
C – The Household sells labor in the market for labor and receives income for that labor
D – The Firm buys labor in the market for labor and pays a wage for that labor.