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Module:

Microeconomics

Lecturer:

Dr Stephen Weir

Microeconomics

Lecture 1 - Introduction

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- Economics is defined as the allocation of scarce resources amongst competing uses
- What does this mean ?

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- Economics is concerned with
  – a. – The production of good and services
  – b. – The consumption of goods and services
  – c. – Scarcity

- A central problem faced by all individuals and societies is the problem of scarcity

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- Human wants are virtually unlimited yet the means of fulfilling them are limited
- At any one time the world can only produce a limited amount of good and services
- Why?
- Because the world has only a limited amount of resources at any one time

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- The resources are known as factors of production (in economic texts)
- They are
  - Land
  - Labour
  - Capital
  - (Enterprise)

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- Land (including natural resources) is limited by the size of the Earth
- Labour is limited in both number and skill
- Capital is by definition inputs that are used in the production of other goods and therefore are limited
- Enterprise – The stock of available knowledge at any one time is limited

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- Scarcity – the excess of human wants over what can actually be produced
- Opportunity Cost – of a good is the quantity of other goods sacrificed to get another unit of that good
- Efficiency - An economy is efficient if it provides the maximum amount of goods, given the resources available to the people who demand them
- Because resources are scarce choices have to be made

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- These choices are
  - What goods and services are produced and in what quantities are they produced
  - How are these goods produced, e.g. labour or capital intensive
  - For whom are these goods produced
- All societies have to make these choices, whether they are made by individuals, groups or governments

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- Different Economic Systems
  - All societies are faced with the problem of scarcity
  - They differ considerably in the way that they tackle the problem

- Three “stylised” types
  - Planned economy
  - Free market economy
  - Mixed economy

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- Planned Economy
  - Factors of production are collectively owned

- The state plans the allocation of resources at three important levels
  - Between current consumption and investment for the future
  - It plans the output of each industry and firm
  - It plans the distribution of output between consumers

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- Problems of a Planned Economy
  - Information overload - Collecting and analysing the details of economic activity is an enormous task e.g. crops rotted because storage and distribution were not co-ordinated
  - Poor incentives – complete job security undermines the incentive to work.
  - Quality - Planners can observe quantity easier than quality. Factory managers therefore had the incentive to skimp on quality

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- Problems of a Planned Economy
  - Inefficiency – If prices are set by government, they will not reflect relative scarcity therefore resources will be used inefficiently
  - Insufficient Competition – No competition between firms meant that there was no comparison on the basis of efficiency

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- Problems of a Planned Economy
  - Consumption – How does the government know that the goods it commands to be produced will be consumed
  - Loss of individual liberty – In order to met plans the government would have to coerce individuals into certain tasks.

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- Free-Market Economy
  - What, How and For Whom decisions are made by individuals
  - Invisible Hand – people motivated by their own self interest also help society
  - Efficient in the "perfect world" (we will examine this in greater details when we look at the government and the market)
  - Problems of inequity ?

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- Mixed Economy
  - The government and private sector jointly solve economic problems
  - The government influences decisions through regulation, taxation, subsidies and the provision of certain services

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- The Economic Rationale for Government
  - The Regulatory Role
  - The Allocative Role
  - The Distributive Role
  - The Stabilisation Role

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- The Role & Function of Markets
  - A decentralised means of allocating resources through the decisions of firms & markets
  - Often an excellent means of making allocation decisions
  - Markets can fail

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- Economics Models and Assumptions
  - Assumptions simplify the complex world, make it easier to understand.
  - Examples: Assumption (1) people are rational (2) there are two factors of production
  - Unrealistic, but simplifies the subject & gives useful insights about the real world.
  - Model: a highly simplified representation of a more complicated reality.
  - Economists use models to study economic issues.

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- Some Familiar Models
  - A road map
  - An Architect's plans
  - A model of human anatomy used in biology class
  - A model car
  - The supply & demand model
  - The circular flow model

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- Economic Models
  - An economic model is a formal presentation of an economic theory
  - An economic model is used to explain and predict
  - A economic model shows a simplified relationship between the economic phenomena it is trying to explain
  - Models can be described verbally but are usually represented in graphical or mathematical form

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- Economists play two roles:
- 1. Scientists: try to explain the world
- 2. Policy advisors: try to improve it
- In the first, economists employ the scientific method: the development and testing of theories about how the world works.

The Economist as Policy Advisor

- As scientists, economists make **positive statements**,
  which attempt to describe the world as it is.
- As policy advisors, economists make **normative statements**, which attempt to prescribe how the world should be.
- Positive statements can be confirmed or refuted, normative cannot as the are value judgements

Microeconomics and Macroeconomics

- **Microeconomics** is the study of how households and firms make decisions and how they interact in markets.
- **Macroeconomics** is the study of economy-wide phenomena, including inflation, unemployment, and economic growth.
- These two branches of economics are closely intertwined, yet distinct—they address different questions.