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An introduction to microeconomics

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The scope of Microeconomic Theory

The prefix *Micro* in microeconomics comes from the Greek Word *mikros*, meaning small. It contrasts with macroeconomics, the other branch economic theory. **Macroeconomics** deals primarily with aggregates, such as the total amount of goods and services produced by society and the absolute level of prices, while **Microeconomics** analyzes the behavior of “small” units: consumers, workers, savers, business managers, firms, individual industries and markets, and so on.

Microeconomics, however, is not limited to “small” issues. Instead, it reflects the fact that many “big” issues can best be understood by recognizing that they are composed of numerous smaller parts. Just as much of our knowledge of chemistry and physics is built on the study of molecules, atoms, and subatomic particles, much of our knowledge of economics is based on the study of individual behavior.

Individuals are the fundamental decision makers in any society. Their decisions, in aggregate, define a society’s economic environment. Consumers decide how much of various goods to purchase, workers decide what jobs to take, and business owners decide how many workers to hire and how much output to produce. Microeconomics encompasses the factors that influence these choices and the way these innumerable small decisions merge to determine the workings of the entire economy. Because prices have important effects on these individual decisions, microeconomics is frequently called **Price Theory**.

The Nature and role of theory

In disciplines from physics to political science, using a theory to make sense of a complex reality is essential. Facts do not always “speak for themselves”. In economics, facts may describe a historical episode, but facts can never explain why the episode occurred or how things would have been different had, for example, the government pursued another policy. Moreover, facts can never demonstrate how, for instance, a change in agricultural prices will affect agricultural production next year. For purposes of explanation or prediction, we must employ a theory that shows how facts are related to one another.

Theory in economics, as in other sciences, is based on certain assumptions. For example, economists assume that firms strive to maximize profit. Based on this assumption, the economic theory of the firm explains what mix of steel and plastic firms such as Toyota and General Motors (GM) employ in production as well as how many cars and trucks they produce. Theory also

explains how Toyota's and GM's desired input mixes and final output levels are affected by changes in, say, the Price of steel or the Price received per car sold.

Economic theory can be used to predict as well as to explain real – world outcomes.

For instance, the basic supply – demand model can explain the effects observed in cities that have enacted rent control laws. It can also predict the effects should the deferal government impose similar Price ceilings on health – care services.

What is a Good Theory?

How do we know if a theory, whether it be in economics, physics, or political science, is a “good” theory? Basically, a theory is considered to be valid and useful if it succesfully explains and predicts the phenomena that it is intended to explain and predict. In keeping with this litmus test, theories are continually stacked up against real – world data. Depending on how well a theory matches the data, the theory is maintained, refined, or sometimes even discarded (perhaps in favor of a competing explanation). The continual process of testing theories against real – world data is critical to the advancement of any science, not just economics.

In testing a theory, it is important to note that imperfection tends to be the norm. That is, “good” theories typically do not explain the observed data perfectly, not are the assumption on which they are based entirely realistic. For example, consider the *calorie theory*, one accepted by millions of people. The calorie theory holds that a person's weight depends on the number of calories consumed per day: the more calories ingested, the heavier the person will be.

Tha calorie theory predicts that to lose weight, a person should cut his or her calorie intake. Is this a valid and useful theory? Consider two criticisms: first, the calorie theory is based on assumptions that are not completely realistic. That is, no one has ever seen a calorie, much less observed the human body convert i tinto weight. Second, the theory is not perfect. Reducing your calorie intake will not necessarily make you thin. Other factors, besides calories, influence a person's weight: heredity, exercise, metabolism, ratio of fat to protein consumption, and so on.

Does this mean that people who count calories are wrong? Not at all. In fact, the calorie theory is quite useful for millions of weight watchers around the world. For them, the general relationship between calories and weight tends to hold and becomes even stronger once the calorie theory is refined to account for other factors such as heredity, excercise, metabolism, and so forth.

Such is the case with economics. While firms may not appear to maximize profit (think about Amazon.com or Biogen), and refinements accounting for special features of particular markets may be necessary (long- run versus short-run profitability in industries where firms must make substantial up-front research and development investments), the economic theory of the firm base don the assumption of profit maximization successfully explains and predicts a wide range

real-world phenomena. Thus the theory is useful to both business managers and public policymakers.

Positive versus Normative Analysis

Economic theory is a tool for understanding relationship in the economy. While it can explain the behavior of market actors, it cannot determine which public policies are desirable and which are not. Economics can help us evaluate the results of public policies, but it never, by itself, demonstrates whether the results are good or bad.

Consider the federal minimum wage – first set in 1938 at \$ 0.25 per hour and periodically increased over the years (to \$7.75 per hour by July 2009). Evaluating the desirability of this policy requires three steps. First, one must determine the qualitative effects of the policy. For example, how does it affect the employment of workers by firms? Does it increase or decrease employment? Second, one must determine the magnitude of the effects. If the minimum wage leads to less employment, how much less? How many workers lose their jobs and how many retain their jobs at the higher wage rate? Finally, a judgment needs to be as to whether the policy's effects are desirable. Does the benefit to workers who remain employed outweigh the costs to those workers whose jobs are cut?

The first step involves identifying the qualitative nature of a policy's consequences. This step is in the realm of **positive analysis**, assessing the expected, objective out-comes. The distinguishing feature of positive analysis is that it deals with propositions that can be tested with respect to both their underlying logic and the empirical evidence. It deals with what is, or what might be, without deciding whether something is right or wrong, good or bad. Positive analysis is scientific because it draws on accepted rules of logic and evidence, of both a qualitative and quantitative nature, that can be used to determine the truth or falsity of statements. Microeconomic theory is a form of positive analysis; it can be used, for example, to make the qualitative prediction that a minimum wage law will reduce employment.

If we want to resolve the question of desirability, however, identifying the qualitative nature of the effects is not sufficient. We also need some idea of the size of the effects. It may matter a great deal whether the minimum wage causes 1 percent or 25 percent of unskilled workers to lose their jobs. Note that this step still involves positive analysis, but in quantitative rather than qualitative terms.

Knowing the consequences, both qualitative and quantitative, is still not sufficient to determine whether a policy is desirable. A final step is necessary: we must decide whether the consequences themselves are, on balance, desirable. To make this evaluation, each person must make a normative analysis, or value judgment. By nature, such a judgment is nonscientific. It cannot be proved right or wrong by facts, evidence, or logic. It stems from the value system of the person making the judgment. For example, a belief that it is desirable to raise the wages of the lowest-paid workers, even at the expense of others, falls into this category. People may agree that a

particular policy has this effect, but some may hold that the outcome is desirable and others that it is not. Their value judgments differ.

Microeconomic theory cannot demonstrate that a particular set of economic institutions or policies is desirable – and neither, for that matter, can any other scientific branch of knowledge. A belief that something is desirable requires a nonscientific judgment of what constitutes desirability, and that value judgment is the domain of normative analysis. Nonetheless, microeconomic theory can assist each of us in reaching such normative judgments by helping us determine the likely outcomes. In other words, microeconomics helps us take the first two of the three steps necessary to evaluate real-world phenomena.

Glossary

Macroeconomics: The study of aggregate economic factors

Microeconomics: The study of the behavior of small economic units such as consumers and firms

Price Theory: Another term for microeconomics

Positive Analysis: Assessment of expected, objective outcomes

Normative Analysis: A nonscientific value judgment

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Lectura



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