

Microeconomic Principles and Policy

Module Introduction and Overview

Contents

1	Introduction to the Module	2
2	The Module Author	3
3	Study Resources	3
4	Module Overview	4
5	Learning Outcomes	7

1 Introduction to the Module

Welcome to the module *Microeconomic Principles and Policy*. We hope that you will find the module stimulating and useful.

The module introduces a wider range of microeconomic theories and applications than only those reflecting traditional or 'neoclassical' views. Some of these are more contentious than others as they have implications for public policy.

There are two narratives or theoretical approaches running through this module. The first is the traditional neoclassical approach, which is based on the assumption that all economic actors behave rationally to improve their own self-interest in markets that are competitive. So consumers want to maximise their satisfaction from the goods and services they consume, while firms want to maximise their returns or profits from the goods and services they produce and it is assumed that consumers and producers have all the information needed to make economic decisions rationally. The neoclassical approach is developed on the basis of this simplified analysis of economic behaviour, although the model can and does get more complex in order to analyse situations where the above assumptions do not hold. Over time this approach has been developed into an elegant model of economic behaviour, expressed in mathematics and also graphically.

The neoclassical narrative has become the basic economic model taught in schools and universities, albeit in some highly complex mathematical forms at post-graduate level. It is a useful model in that it enables us to analyse key economic relationships within the context of the model's assumptions. However, in the real world, economic agents do not necessarily behave rationally so as to maximise their own self-interest. For instance, consumers' decisions may be influenced by habits or advertising, while large corporations may be motivated by wanting to acquire market concentration as well as earning profits.

So the second narrative running through this module covers alternative approaches that have been developed to analyse economic behaviours. In particular, you will be learning about the behavioural approaches to consumer theory as well as alternative models for analysing producer behaviour and market structures.

However, it is important to note that there are no right or wrong models of economic behaviour, but rather a spectrum of approaches based on different underlying assumptions of how economic actors behave. In some cases, these models also reflect political ideologies. So, for example, the neoclassical approach and its focus on the primacy of markets as the modality of economic actors' interaction is often viewed as being aligned with more conservative-based political approaches whereas some of the alternative approaches are often viewed as being more closely aligned with more liberal political stances.

It is not the purpose of this module to promote one or other of these narratives – rather it is to introduce you to the range of models, analytical tools and examples to help you to form and express your own views.

As you work through the module materials, there are various exercises that are designed to consolidate your knowledge and skills. We recommend that you do the exercises, most of which take half an hour or less, before you look at any model answers that are given in the unit.

At certain points we will ask you to reflect on various aspects of the policy and processes relevant to your own place of work. It will be valuable for you and your fellow students to share these reflections on the VLE (the Virtual Learning Environment). Short notes setting out the issue and the approach will enrich your, and your fellow students', experience of the module.

Please feel free to raise queries with your tutor and with your fellow students if there are things that are not clear to you. Do this as soon as you find a problem, because waiting will hold you up as you work through the module.

2 The Module Author

Alison Johnson is an Associate of Development Finance International, which works with developing country governments to develop the full independent capacity to design and execute their own national resource mobilisation and debt strategies and policies. She also has experience in preparing analytical studies and training materials on aid and debt issues for the United Nations, African Development Bank, Commonwealth Secretariat, Oxfam and other organisations.

Prior to this, she was Acting Director of the Centre for International Education in Economics (precursor of CeFiMS), with responsibility for policy and operations of the postgraduate programmes in economics, finance and development by distance learning, and Lecturer in Economics at SOAS with responsibility for designing and writing distance learning economics modules. She was the convenor and principal author of the modules on economic principles, and she also has extensive experience of writing practically-focused training materials and running workshops.

3 Study Resources

There are two key texts for this module:

Goodwin N, J Harris, JA Nelson, B Roach & M Torras (2014) *Microeconomics in Context*. 3rd Edition. New York: ME Sharpe.

This book is designed to provide an introduction to most of the topics you will be studying in this module. However, it is different from the standard microeconomics textbook in that its focus is wider than just the traditional neoclassical approach. Not only does it take account of alternative theories but also its presentation is broader based, focusing on consumption and

production decision-making within the context of an economic system. So it is aligned more with the traditional notion of political economy, than the narrower more mathematical discipline that economics became in the twentieth century.

This book is non-mathematical, as is this module. While it does use a few equations in some of its technical annexes, much of the exposition is done in terms of diagrams. At the end of the book there is a useful glossary of terms.

Pindyck RS & DL Rubinfeld (2018) *Microeconomics*. 9th Global Edition.
Harlow UK: Pearson Education.

The Pindyck and Rubinfeld text covers all the basic theory and provides you with plenty of examples of its applications. At the end of each chapter of this book, the authors set Questions for Review and Exercises, and I recommend that you jot down at least brief answers to these.

The one drawback to these and many other textbooks is their American orientation. So you will find that most of the applications and real world examples quoted in the textbooks are American, with a smattering of a few from elsewhere. To counterbalance this, the module introduces non-American applications and examples, while noting that many of these are European-focused, with the use of African, Asian and Latin American circumstances where possible.

In addition to the key texts, you will be instructed to study the module readings, made up of chapters and extracts of other books, and articles from respected academic economic journals, international organisations and newspapers. Some of the extracts and articles are concerned with economic models and concepts whereas others discuss applications and policy aspects of the theory.

At the end of each unit you will find a list of optional readings, which are there for you to follow up if you are interested in pursuing some of the unit topics in more detail. In addition, you are encouraged to look at the reference section of the articles included as module readings, as these too will provide you with further articles or readings to explore if you are interested. The additional readings are not compulsory, but rather they are there for you to refer to if you have time and motivation.

In several of the exercises in the units you will be invited to submit summaries of your answers to the Virtual Learning Environment (VLE), and you are urged to do this, to start a dialogue with fellow students and to share your ideas and experiences of the topics studied in the module.

4 Module Overview

The module is structured in the following way. Unit 1 is an introduction to Microeconomics providing an overview of market economic activity and supply and demand. Unit 2 is concerned with the theory of consumer behaviour which underpins the concept of consumer demand. As well as discussing the

neoclassical model, the newer behavioural approaches to consumer demand are introduced. In addition, the second unit demonstrates how both the neoclassical and behavioural models can be used to analyse consumer saving and borrowing decisions.

Units 3 to 5 are concerned with the neoclassical model of production and costs. While Unit 3 is concerned with the basics of neoclassical cost and production theory, Units 4 and 5 focus on the firm's pricing and output decisions in markets where there is perfect competition, monopoly and monopsony power, monopolistic competition and oligopoly. Unit 5 is devoted to the latter as the theoretical models are both more complicated and provide a better reflection of decision making in the real world. The units discuss examples of the different market types, such as the degree of competition in Russian banking, and price wars and collusion in China's airline industry.

Unit 6 is concerned with the markets for inputs (or 'factors of production'), including the markets for labour, manufactured capital, social capital, natural resources and finance. It looks at the neoclassical models as well as other theoretical approaches.

Units 7 and 8 are concerned with bigger picture issues, such as alternative models of firms' behaviour in modern industrial structures, the impact of globalisation on firms' decision making, the role of government in market economies and economic systems. In doing so, Unit 7 looks at case studies, such as price bundling behaviour in the telecommunications industry and the economic behaviour of two very different companies – the American company Wal-Mart and Swedish company IKEA in their efforts to expand globally. Unit 8 is concerned with the role of government in a market economy and how this reflects the prevailing economic system. The module ends with a discussion of how the theoretical concepts and models of microeconomics can be used in environmental economics.

Some of the units are more theoretical in nature than others, and you may find that some require more time to complete than others. This is especially the case if microeconomics is new to you. If you have previously studied microeconomics then you will find that much of the traditional theory covered in the module is familiar to you. However, many of the readings will update the theoretical ideas and/or applications and so you are encouraged to do the readings as well as reviewing your knowledge.

Unit 1 provides an introduction to the basic concepts of demand and supply, which will be familiar if you have previously studied a microeconomics module. But if this is your first encounter with economics and microeconomics in particular, you may find you need to spend a bit more time studying the unit. Unit 2 covers both the neoclassical and behavioural approaches to consumer theory and so it is going to take you longer to do all the readings, than, for example, Unit 3, which concerns the neoclassical theory of production and costs. However, this may be to your advantage as you will probably be working on your first assignment when you come to study Units 3 and 4.

Similarly, Units 5 and 6 may take you more time to complete than Unit 4 because of the greater complexity in studying theories of oligopolistic markets and theories of factor markets, respectively.

On the other hand, you will probably find Units 7 and 8 less theoretical and more accessible, as they are concerned with present day economic problems such as the pricing behaviours of multinational firms, globalisation of business and the role of government.

Unit 1 Introduction to Microeconomics

- 1.1 Introduction
- 1.2 Markets
- 1.3 Supply and Demand
- 1.4 Elasticity
- 1.5 Conclusion

Unit 2 Theories of Consumer Behaviour

- 2.1 Introduction
- 2.2 Traditional Approach of Utility Theory
- 2.3 Limitations of the Consumer Theory
- 2.4 Behavioural Approach
- 2.5 Policy Issues
- 2.6 Conclusion

Unit 3 Theory of Production and Costs

- 3.1 Introduction
- 3.2 Types of Resources Used in Production
- 3.3 Production and Costs
- 3.4 Production Decisions
- 3.5 Analysing Costs and Production
- 3.6 Conclusion

Unit 4 Markets and Competition

- 4.1 Introduction
- 4.2 Perfect Competition
- 4.3 Non-Competitive Market Structures – Monopoly
- 4.4 Monopsony
- 4.5 Non-Competitive Market Structures – Monopolistic Competition
- 4.6 Conclusion

Unit 5 Oligopoly and Other Noncompetitive Markets

- 5.1 Introduction
- 5.2 Oligopoly Models of Output Decision-Making
- 5.3 Oligopoly Models of Price Competition
- 5.4 Game Theory
- 5.5 Collusion by Firms
- 5.6 Prohibiting Collusion
- 5.7 Case Study – China's Airline Markets
- 5.8 Conclusion

Unit 6 Markets for Resources – Labour, Capital and Other Inputs

- 6.1 Introduction
- 6.2 Labour Markets
- 6.3 Manufacture, Natural and Social Capital Markets
- 6.4 Finance Capital
- 6.5 Conclusion

Unit 7 Industry Structures, Pricing Behaviour and Globalisation

- 7.1 Introduction
- 7.2 Alternative Theories of Firms' Behaviour
- 7.3 Big Business
- 7.4 Pricing Behaviour
- 7.5 Globalisation
- 7.6 Conclusion

Unit 8 Microeconomics Applied to Externalities, Public Goods and Environmental Economics

- 8.1 Introduction
- 8.2 Externalities and Public Goods
- 8.3 Direct Public Provision: The Changing Role of State Owned Enterprises
- 8.4 Environmental Economics
- 8.5 Conclusion

5 Learning Outcomes

When you have completed your study of this module, you will be able to:

- explain the principles underlying consumer demand from different perspectives
- discuss what economists mean by the 'theory of the firm'
- spell out the implications of competitive and noncompetitive market structures for the firm's pricing and output decisions
- evaluate how firms respond to the pricing and output decisions of other firms in the market
- debate the importance of the markets for inputs or factors of production, such as labour, capital and natural resources
- analyse how firms expand and the implications for market structure
- discuss how globalisation has influenced the firm's behaviour and the implications for pricing and output decisions.