

Microeconomics: A Very Short Introduction

By Avinash Dixit

Questions for Reading and Discussion

- What significant price changes have you experienced in the last few years and how have they led to changes in your purchase, work, and saving decisions? Include temporary price changes (for example seasonal or special sales), swings in gasoline prices, house price increases (or price drops after the housing bubble burst in 2007-8), any tax changes, inflation (a general increase in all prices) and so on. Relate your behavior to the concepts of substitution, complementarity, and income effects.
- Conduct the following thought experiments: (a) There is a 50% chance that you will lose \$1,000. You can pay x for a contract that will make good your loss if it occurs. What is the largest x that you would be willing to pay? (b) You can pay y for a lottery ticket that will win you \$1,000 with a 50% chance. What is the largest y that you would be willing to pay? Is your answer in (a) bigger or smaller than that in (b)? What reasons can explain the difference?
- IHS, an independent research company, reported that the 16GB iPhone 5S costs Apple approximately \$199 to manufacture, and its retail price starts at \$649. What reasons might explain the big profit margin? Think of competition or monopoly in markets for the final product and its components, supply elasticities in the markets for the components and inputs like labor and materials that go into making the components, fixed costs of research and design, and so on. Don't forget that demand and supply both have a role in price determination. For more details on the cost breakdown, see the article "Teardowns reveal Apple's customary high margins for both iPhone 5S and 5C" by Gregg Keizer, posted September 25, 2013, on <http://www.computerworld.com>
- When the legendary New York politician and 1928 Democratic presidential candidate Alfred E. Smith was a boy, he had to leave school and take up a job as assistant bookkeeper for one of the stall owners in the Fulton Fish Market. His day started at 4 a.m. His first task was to go up to the market roof with a pair of binoculars to watch for the boats sailing in with their catch, and report to his employer how high the boats were riding in the water. How did the employer find this information useful?
- Picture a mile-long beach on a hot summer afternoon. People are spread out along its length, not necessarily with uniform density per length of the beach. There are two ice-cream stalls, one at each end. Each has considerable market power over customers close to it: they would find it too far to walk to the other

stall even if it offered a better price. But customers near the middle are more responsive to price. For what kind of distribution of people along the beach will the ice-cream market be close to two separate monopolies, and when will it be close to perfect competition? Think of other applications of the same idea, for example political competition between two ideologically polarized parties to win the votes of citizens whose own ideological preferences are spread out along the left-right spectrum between the parties.

- Many products are sold using price schedules that offer quantity discounts. In contrast, some manufacturers of laser printers sell them for a very low price, but then charge quite high prices for the ink cartridges, so in effect the price you pay is higher the more heavily you use the printer – a quantity premium on the price. Can these practices serve screening purposes? How?
- A firm engaged in mining, petroleum drilling etc. has to decide not only how much to produce during a given month or year, but also when to produce. The opportunity cost of extracting more now consists of having less available to extract later, and vice versa. How will this firm's supply decisions over time depend on its beliefs about the time path of the price of the resource? How will interest rates figure into the decision?
- In principle, there can be markets where one thing is traded for another – apples exchanged for oranges, shirts exchanged for smartphones, and so on. In practice we have markets where everything is traded for money. Why? (Think transaction costs of various kinds.) Again in principle, lots of things can serve the role of the money that constitutes one side of all markets. What are the desirable properties of the thing that should be chosen for this role? To what extent do the things that have been used at various times in various markets – cowrie shells, gold or silver, paper bills, bitcoins, and so on – have or lack these properties?
- In the market for labor services the price is the wage rate, and the quantity is the number of hours of work demanded by firms and supplied by workers. What are some reasons, including policies, why disequilibrium may persist (supply and demand may fail to equalize) in this market?
- In university student residences some people like loud music and others don't. The former exert a negative externality on the latter. Think of various Coasian, Pigouvian, and other methods for tackling this problem. Which do you prefer and why?
- In the private market for used cars, a nicely washed and clean car should not be an effective signal of its mechanical quality, because the owner of a mechanically

imperfect car can get it washed and cleaned for the same cost as the owner of a mechanically perfect car. But as a buyer you would be suspicious of a dirty or badly cluttered car. What is the cleanliness signaling and why might it be effective to some extent? Along the same lines, can the way you dress for a job interview be an effective signal of your quality as a potential worker, given that anyone can buy those clothes for the same price?

- The Marxist ideal is: “From each according to his ability; to each according to his need.” What problems of information and incentives will arise when a society tries to implement these principles? What compromises with the ideal will have to be made to cope with these problems?
- When my book manuscript goes through the printing process, I have to read proofs and correct any errors. But by that time I have read my own drafts so many times that I start to see what should be there rather than what is there. To ensure good proofreading, I have to hire someone else, typically a student. How should the student be paid? If paid a flat sum, he/she may simply sit on the proofs for two weeks, come back and say there are no errors. I would not know any better without doing the reading myself; by the time other readers tell me about errors the student has been paid and it is too late to do anything. If offered a piece rate per error found, the student may worry that there may be no errors and he/she may spend two weeks without getting any money, and therefore refuse to take the job. What payment scheme will create the right set of incentives?
- Taxes create dead-weight losses by reducing economic activity. Therefore the best candidates for taxation should be those goods and services for which this reduction is smallest, that is, those with very price-unresponsive (highly inelastic) demands or supplies. Think of some such goods and services. Will taxing them lead to some undesirable side-effect? For example, will that hurt the poor disproportionately more?
- A committee of three members A, B and C has to choose one of three alternatives x, y and z. For A, x is best, y next, and z last. B regards y to be best, z second, and x last. C thinks z is best, x next, and y last. What should be chosen? Why?
- You have probably bought or sold things on eBay or similar sites. Recall your experience of search, including price discovery, concerns about quality, and so on. Based on that, in what respects do you think these transaction institutions are superior to conventional markets, and in what respects are they worse?

- A basic difficulty about selling information is that the buyer cannot know how much he or she is willing to pay for it without knowing what it is, but once he or she knows there is no need to pay anything! How is this problem solved (at least partially) in practice? Think of examples, not just in business but also including espionage, crime thrillers, and other sources.
- How is Pareto efficiency improved or worsened, and what redistributive and ethical concerns arise, if: (a) childless couples in rich countries adopt orphans from poor countries, (b) childless couples in rich countries pay parents in poor countries to adopt their children, (c) a poor woman bears a baby for a rich couple who cannot do so in the normal way, in exchange for money, (d) a poor person sells one of his kidneys to a rich person who needs a transplant? Also think of other situations and conflicts of this kind.

Other books by Avinash Dixit

- *Optimization in Economic Theory* (Oxford University Press 1976, Second edition 1990)
- *The Theory of Equilibrium Growth* (Oxford University Press 1976)
- *Theory of International Trade*, with Victor Norman (Cambridge University Press 1980)
- *Thinking Strategically: The Competitive Edge in Business, Politics, and Everyday Life*, with Barry Nalebuff (W.W. Norton, 1991)
- *Investment Under Uncertainty*, with Robert S. Pindyck (Princeton University Press) 1994
- *The Making of Economic Policy: A Transaction Cost Politics* (M.I.T. Press, 1996)
- *Lawlessness and Economics: Alternative Modes of Governance* (Princeton University Press, 2004)
- *The Art of Strategy: A Game-Theorist's Guide to Success in Business and Life* with Barry Nalebuff (W. W. Norton, 2008)
- *Games of Strategy*, with Susan Skeath and David Riley, third edition (W. W. Norton & Company 2009)

Further Reading

- *Reinventing the Bazaar*, John McMillan (W.W. Norton 2002)
- *The Undercover Economist*, Tim Harford (Oxford University Press 2006)
- *A Splendid Exchange: How Trade Shaped the World*, William J. Bernstein (Atlantic Monthly Press, 2008)

- *Manias, Panics, and Crashes: A History of Financial Crises*, Charles Kindleberger (Basic Books, 1978)
- *Auctions: Theory and Practice*, Paul Klemperer (Princeton University Press, 2004)