Microeconomic Theory II

Economics is a science. A unique science no doubt, as we will discuss, but a science nevertheless. Learning to apply that science appropriately, however, is an art. Though they are related to one another, there are important and subtle distinctions between the science of economics and the art of political economy. It is my hope that this class will help you solidify your understanding of the science of economics, and serve as an aid in your continued effort to cultivate your abilities in the art of political economy.

You are PhD students who have for your own variety of reasons decided to pursue a career as a professional economist. I urge you to invest appropriately in learning how to think like an economist, and how to practice economic science and the art of political economy. Here is a motto that might help you contemplate the trade-offs you will be asked to make in the course of your studies: Work in Proportion to your Aspirations. I am a big believer that success in science is primarily a function of letting your curiosity guide you, learning to trust in your judgement over which direction that curiosity guides you, and finding, and believing, in your own voice as a thinker and communicator to your peers, to your students, and to other interested individuals. As an educator, part of my job is to help facilitate that process in each of you. But, it is important to remember that education is a classic example of co-production, you get out of this what you put into it. I want to suggest this moment in time is your opportunity to make an investment in human capital that if you do it right, you will be able to draw on for the rest of your career.

In many ways, economic is applied common-sense, but in other ways it defies the intellectual patience of many because the chains of reasoning can indeed be long and difficult to follow. At the most fundamental level, economic analysis begins with the recognition that we live in a world of scarcity. This scarcity condition is not appropriately understood as related to material abundance, but instead to the simple logic that we cannot be in two places at once. Thus, all our actions require trade-offs, and the setting aside of one path in order to choose another. Humans need guideposts in helping them make assessments of the trade-offs, and learning mechanisms so they improve through time and thus are capable of judicious decision making. We do not willingly make bad decisions and injudicious use of our time, energy and resources. Humans are purposive beings, who have desires and aspirations to substitute more satisfactory situations for less satisfactory ones. In short, we strive to achieve our goals, we are aspirational creatures.

From the primordial existence of scarcity, we get the necessity and agony of choice, and our choices are always made against given constraints. We strive to do the best we can in any given situation we find ourselves. To analyze human behavior as an outside observer, we must give weight to the striving and to the situation. In classic social science debates, this is captured in the Agency vs Structure discussion. Economics, I would argue, was uniquely situated to avoid the over-theorizing and under-theorizing claims that have plagued this debate in anthropology, history, politics and sociology, and to blend agency and structure into the core theorizing represented by the mainline of
economics from Adam Smith to Vernon Smith. A theme we will stress throughout the term will be how in this mainline tradition the “invisible hand theorem” is derived from the “rational choice postulate” via “comparative institutional analysis”. How we do this as economic theorist is through examining how alternative institutional arrangements impact, through the structure of incentives and the flow and quality of information produced, the ability of ordinary individuals to pursue productive specialization and realize peaceful social cooperation through exchange. The study of choice against constraints, the role of incentives and information in shaping those choices and directing social interactions, and the consequences of alternative institutional arrangements on those choices and those social interactions is the stuff of microeconomics. Within microeconomics broadly defined, there are theoretical approaches that could best be described as choice theoretic and others that could be described as price theoretic, we will be focusing on price theoretic. Namely, the role that property, prices and profit-and-loss play in coordinating economic activity among individuals through time.

Also, within microeconomics you have traditions that could be described as allocation paradigm and others best described as exchange paradigm, we will be focused on detailing the implications of pursuing the exchange paradigm. The central idea is that economic science is about exchange, and the institutions within which exchange relations are forged, acted upon, and change over time. From Adam Smith’s observations about “the butcher, the baker and the brewer” to F. A. Hayek’s “market for tin” or James Buchanan’s “mosquito swamp”, the questions all follow from the human propensity to truck, barter and exchange.

I stress price theoretic and exchange paradigm precisely because in my judgement most microeconomics is taught in the choice theory and allocation paradigm approach, and as a result certain critical insights from the science of economics are lost in the subsequent practice of the art of political economy. The most obvious of these was the mid-20th century effort to derive an “institutionally antiseptic” theory of market failure and of government correctives through interventions, regulations, and planning. This course is not focused on the public policy issues, but on the methodological and analytical methods that resulted in what I consider erroneous views in the area of public policy. And, thus, what methodological and analytical methods would perhaps avoid those errors. This is most highlighted in discussions of optimization and equilibrium and to what use we employ those terms in our analysis -- are they “as if” descriptions, are they “benchmarks” to judge activity and outcomes against, or are they a “foil” to aid us in understanding a world in flux, of ceaseless change, adaptation and adjustment? How one answers determines in many ways what type of economist one becomes, and how that economist will practice the science of economics and the art of political economy. I fully recognize that this is an ongoing and contested conversation throughout the related but distinct disciplines of economics and political economy. My main goal is to prepare you to become active participants in that contested conversation.

With that goal in mind, I have assigned 3 textbooks from which the core of your weekly reading will come. They are:


In addition, it should be acknowledged that the standard textbook across PhD training is none of these works, but instead the book by Andreu Mas-Colell, Michael Whinston, and Jerry Green *Microeconomic Theory* (Oxford University Press, 1995). A lot can be learned by looking at the dominant textbook that is utilized in this course over time. Through the years that textbook has moved from Alfred Marshall’s *Principles*, to George Stigler’s *Theory of Price*, to Paul Samuelson’s *Foundations*, to Hal Varian’s *Microeconomics*, to David Kreps’s *A Course in Microeconomics*, to today with Mas-Colell, Whinston and Green. And, the tools and techniques shifted as well from supply and demand, to competition and monopoly theory, to linear programming and operations research, to optimization and equilibrium, to game theory. But a central theoretical core remains even throughout this evolution, namely the rational choice postulate and the invisible hand theorem as already alluded to earlier in this syllabus. It is my contention, however, that this conversation gets off track because institutional analysis is squeezed out by many of these tools and techniques. *Bringing institutions back into economics is actually more transformative than most are willing to recognize.*

But discomfort with the current dominate approach to microeconomics is evident in the effort in recent years by the economists at the University of Chicago to expose graduate students from elite universities to “Chicago Price Theory” each summer. (see https://bfi.uchicago.edu/initiative/price-theory/) Kevin Murphy and his colleagues have a strong sense of urgency in their efforts and they believe that core economic theory is being taught wrong at most universities and they are offering an alternative. So along with my approach, you should familiarize yourself with the book by Sonia Jaffe, Robert Minton, Casey Mulligan and Kevin Murphy, *Chicago Price Theory* (Princeton University Press, 2019), and the video lectures that accompany the book … https://www.youtube.com/channel/UC54kFKpGsipyAgNSce-mR6Q

The discomfort also led to efforts by the Institute for New Economic Thinking (INET) and through the initiative of Duncan Foley at the New School for Social Research, and you can also follow his video lectures https://www.youtube.com/watch?v=2jFG4sN0Cl4

There is also the INET course “Advanced Microeconomics for the Critical Mind” taught by Sanjay Reddy and Raphaële Chappe https://www.ineteconomics.org/education/courses/advanced-microeconomics-for-the-critical-mind

And more recently there is a series of lectures by Ha-Joon Chang of Cambridge University through INETentitled “Economic for People” https://www.ineteconomics.org/perspectives/videos/economics-for-people

There is also the discomfort expressed in the CORE project, which seeks to transform how economic instruction takes place from the principles level to the advanced graduate level. So discomfort with the current way economics is taught, is practiced, and is communicated is wide-spread.
As I said earlier, it is my hope that this class will aid in your preparation to become an active participant in this contested conversation. Exposure to these alternative points of view are critical for you to be able to contribute. *But the most important aspect of contributing to a contested conversation is to actually have something to contribute.* This class will hopefully aid you in that primary task first and foremost. I am pointing to the alternative approaches to this material, but we will not be exploring them in any depth. I encourage you to do that on your own, and perhaps bring insights from what you have learned into the class discussion.

Besides the reading from the textbooks, each week prior to class you will be required to watch a video interview/lecture and you will be quizzed on this material, there will also be a limited number of journal articles and speeches you are to read throughout the term, and there will be assigned problem sets and/or essays. The class is 3 hours long, the quiz will be 10-15 minutes, the lecture will be 60-90 minutes depending on the topic, we will have discussion of various papers largely drawn from the *Journal of Economic Literature* (students will be assigned to give 10 minute presentations), and the assignment of problem sets/or short essays will be handed out. The problem sets will come from classic workbooks, such as Henry Simons’ *Syllabus* from the 1930s and 1940s to more recently Matt Kahn’s *Price Theory Problems*, or other random sources including your textbooks, and the essays will be motivated by the reading materials and topics discussed in class.

You will notice a pattern quickly. I draw from videos of Nobel Prize winning economists, and also expect you to read their prize lectures. This again will give a wide scope of the contested conversation historically understood. There is a problem with this approach, which I am the first to admit -- the Nobel is in many ways a lagging indicator, whereas the Clark Medal is a leading indicator for economic research. I hope my selection will overcome that bias, though I am aware that my preferences in the economic conversation will show through in the selection as well.

Here is the semester schedule, please make sure to do all the assignments and readings.

**January 21 -- Course Introduction**

Prior to class watch this conversation between Gary Becker and Ronald Coase

- [https://www.youtube.com/watch?v=iTdJcGjWVz0](https://www.youtube.com/watch?v=iTdJcGjWVz0)
- Also read their respective Nobel biography and lectures

For Class discussion read:

- Alchian and Allen, 1-2.
January 28 -- Methodology and Method in Economics
Prior to class watch this interview with Daniel Hausman and his paper on methodology
❗️ https://www.youtube.com/watch?v=EfF6WD8s_ps

For class discussion read:
❗️ Campbell, chapter 1-2

February 4 -- Incentives and Information in Individual Choice, in the Firm and in the Market
Prior to class watch and read the Nobel lecture by Oliver Williamson

For class discussion read:
❗️ Alchian and Allen, 3; 4-5; 22-23
❗️ Milgrom and Roberts, 1-4
❗️ Campbell, 4

February 11 -- Traditional Welfare Economics
Prior to class watch the Nobel interview with Kenneth Arrow
❗️ https://www.nobelprize.org/prizes/economic-sciences/1972/arrow/interview/

And read the respective Nobel Lectures of Arrow and Amartya Sen

For class discussion read;


Alchian and Allen, 10, 13, 35

Milgrom and Roberts, 3-4, 8, and 9

Campbell, 11

February 18 -- Modern Welfare Economics
Prior to class watch and read the Nobel lecture by Joseph Stiglitz


For class discussion read:


Milgrom and Roberts, 5-6

Campbell, 8

February 25 -- The Hayek Hypothesis
Prior to class watch and read the Nobel lecture by Vernon Smith


For class discussion read:


Alchian and Allen, 16-20

Milgrom and Roberts, 3-4

Campbell, 6, 9.

March 3 -- MID-TERM

March 10 -- No Class SPRING BREAK

March 17 -- Coordination and Cooperation
Prior to class watch and read the Nobel lecture by Oliver Hart


For class discussion read:

March 24 -- Rents, Regulations and Rules
Prior to class watch this interview with George Stigler and read his Nobel Lecture

- https://youtu.be/7Cnm_YWJlSQ

For class discussion read:
- Alchian and Allen, 19
- Milgrom and Roberts, 5, 8, 12-13
- Campbell, 3, 5

March 31 -- Positive Economics, Welfare Economics and Political Economy
Prior to class watch this interview with James Buchanan and read his Nobel Lecture

- https://www.econlib.org/archives/2013/10/james_buchanan_conversation.html

For class discussion read:
- Alchian and Allen, 12-13
- Milgrom and Roberts, 9, 16-17
- Campbell 7-8

April 7 -- NO CLASS -- APEE Meetings

April 14 -- Creativity and the Market Process
Prior to class watch and read the Nobel lecture by Paul Romer


For class discussion read:


Alchian and Allen, 10, 17-18, 34

Milgrom and Roberts 7, 10-11

Campbell, 9

April 21 -- Economics in Three Lessons
Prior to class watch and read the Nobel Lecture from Jean Tirole

For class discussion read:
- Alchian and Allen, 5-6, 8
- Milgrom and Roberts, 7-9
- Campbell, 7-8, 11

April 28 -- The Lessons from the Grand Debate
Prior to class watch and read the Nobel Lectures from 2007 winners Hurwicz, Maskin, and Myerson, as well as the earlier Nobel Lecture by Douglass North

For class discussion:
- Alchian and Allen, 10, 13, 30-31
- Milgrom and Roberts, 1, 17
- Campbell, 1, 11

May 5 -- Contemporary Research in Economics, Political Economy and Social Philosophy
Prior to class watch and read the Nobel Lectures from Elinor Ostrom and Esther Duflo

For class discussion:
May 12 -- FINAL EXAM

A final note on Course Objectives & Grading

As I mentioned earlier, you should Work in Proportion to your Aspirations, and make the appropriate investments in your time, energy and resources based on that. You will get out of this class what you put into it, as a classic example of co-production. However, it is my objective and the purpose behind all the assignments that upon completion of this course, you will:

- Understand the foundations of Advanced Microeconomic Theory
- Understand the major strands of academic literature in Advanced Microeconomic Theory
- Be able to synthesize existing ideas in the field of Advanced Microeconomic Theory and build on these ideas to generate novel contributions to this literature
- For PhD students - be able to write academic papers in the distinct but related fields of economics and political economy suitable for peer review and become active participants in the contested conversation in our scientific profession.

To meet these course objectives, we will have multiple assignments and exams that will be graded. First, you will have quizzes worth 15 points each and there will be 10 of them for a total of 150 points. Second, you will have problem sets and/or short essays that will be worth 15 points each, and you will have to complete 10 of those through the semester for 150 points. Finally, you will have a mid-term worth 100 points and a final worth 100 points. All points are equally weighted, so your grade will be based on 500 potential points with 450< being an A, 400-449 -- B, and 350-399 -- C, below 349 -- unsatisfactory performance. I do expect consistent attendance and active participation in class discussions, including not only the students presenting the papers for discussion that week but all the students so everyone should come prepared with at least 2 questions per paper assigned each week.