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Economics for All Students

By Paul Seabright

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For the last half-century, the world's leading universities have taught microeconomics through the lens of the Arrow-Debreu model of general competitive equilibrium. The model, formalizing a central insight of Adam Smith's "The Wealth of Nations," embodies the beauty, simplicity and lack of realism of the two fundamental theorems of competitive equilibrium, in contrast to the messiness and complexity of modifications made by economists in an effort to capture better the way the world actually functions. In other words, while researchers attempt to grasp complex, real-world situations, students are pondering unrealistic hypotheticals.

This educational approach stems largely from the sensible idea that a framework for thinking about economic problems is more useful to students than a ragbag of models. But it has become burdened with another, more pernicious notion. As departures from the Arrow--Debreu model become more realistic, and thus more complex, they become less suitable for the classroom. In other words, "real" microeconomic thinking should be left to the experts.

Undergraduate-level courses in microeconomics should empower students and give them insights into real-life situations.

To be sure, basic models — such as theories of monopoly and simple oligopoly, the theory of public goods or simple asymmetric-information theory — have some educational value. But few researchers actually work with them. The bread-and-butter theories for microeconomics research — for example, incomplete contracts, two-sided markets, risk analysis, market signaling or financial-market microstructure — are far more complicated and require exceptional finesse to avoid inelegance. Given this, they are largely excluded from textbooks.

In fact, microeconomics textbooks have remained practically unchanged for at least two decades. As a result, undergraduate students struggle to understand even the abstracts of papers on the complex representations of microeconomic reality that fill research journals. And, in many areas — such as antitrust analysis, auction design, taxation, environmental policy, and industrial and financial regulation — policy applications have come to be considered the domain of specialists.

This does not have to be the case. While it is true that realistic microeconomic models are more complex than their idealized textbook counterparts, grasping them does not necessarily require years of research experience.

A case in point is the economics of two-sided markets, which involve competition between platforms whose principal "product" consists in connecting two categories of users, who then offer each other network benefits. When markets are two-sided, many of the standard assumptions of antitrust analysis no longer hold. Market entry can be bad for consumers, exclusive contracts can increase the number of firms in a market, and pricing below cost may not be predatory.

But every behavioral divergence between two-sided and traditional markets can be understood using simple tools of elementary microeconomics, such as the distinction between substitute and complementary products. When producers of substitutes collude, they usually raise prices; producers of complements, by contrast, collaborate to lower them.

So if two platforms that appear to be performing similar services are complementary — for example, because one platform connects consumers with a set of users that helps them to value another set of users more highly — market entry can be bad for consumers. In fact, two platforms can even be complementary for one set of users and substitutes for another.

Moreover, exclusive dealing can increase competition by allowing two platforms to occupy distinct market niches, with the alternative being that one drives out the other. In short, with

a solid understanding of the difference between complements and substitutes, one can do almost everything the fancy models do without hiring a single expensive expert.

Undergraduate-level microeconomics should empower students, not alienate them. While the Arrow-Debreu model has its value — namely, it explains why an unplanned economy can produce order — it is discouraging for students to find that what they are deemed capable of comprehending offers little insight into real-life situations.

Restructuring the microeconomics syllabus would send a far more inspiring, and accurate, message: Even complex ideas developed by experts can be understood and applied by educated laypeople.

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