Microeconomics 1 as it Should Be

*Tim Harford, **The Undercover Economist**, Little, Brown, UK, 2006*

*Reviewed by **Declan Trott***

Who pays for your coffee? With this simple yet wrong (think about it!) question, *Financial Times* columnist Tim Harford begins his discussion of David Ricardo's theory of economic rent. Using as his main example, not the original corn lands or mines, but coffee stands in prime locations such as London's Waterloo station, he shows how the rents of the best locations are governed by the worst, the marginal sites at which the price can just cover the cost of production. 'Undercover', then, does not imply danger, illegality or breathtaking revelations, just a man going about his everyday business with a few extra intellectual tools to make sense of the world around him. This sets the pattern for the rest of the book: economic theory used to make sense of quirky yet commonplace situations.

Fortunately, the chapter titles make more sense after the first. 'What Supermarkets Don't Want You to Know' illustrates the different forms of price discrimination, covering not only supermarkets but railways, pharmaceuticals and airlines. 'Perfect Markets and the "World of Truth"', unsurprisingly, sketches how a world of perfectly competitive markets could bring about efficient outcomes, 'Crosstown Traffic' and 'The Inside Story' how externalities and asymmetric information spoil this story. 'Rational Insanity' is an apt a description as any of herding in financial markets, while 'The Men Who Knew the Value of Nothing' is not a description of mad economists selling rain forests and small children but an excursion into game theory via the trials and tribulations of radio-spectrum auctions. 'Why Poor Countries Are Poor', 'Beer, Chips and Globalisation' and 'How China Grew Rich' are more standard applications of comparative advantage and Olsen's stationary bandit theory.

It is easy to praise this book. In a market where introductory textbooks are growing ever larger, more colourful, and more expensive, the author has taken some of the most important ideas in economics, made them as simple as they can be (but no simpler), and related them to examples that are real, relevant and interesting. All in around 250 pages with 5 simple black and white graphs. The opinions and policy prescriptions are unsurprising for a Financial Times columnist — free trade is good, environmental and fair trade activists are often misguided, tradeable permits and taxes are the best way to solve pollution and congestion. (Unfortunately, Bastiat's famous quip about throwing rocks in your own harbour is attributed to Joan Robinson, which surely has them both spinning in their graves!) Yet while Harford exhibits flashes of unjustified dogmatism — 'trade

barriers will always do more harm than good' and holding up South Korea as a shining example of free trade — his views are generally more nuanced, separating goods trade and direct investment from financial openness in his discussion on globalization, and praising China's pursuit of gradual reforms and 'growing out of the plan', rather than fire-sale privatization Russian style. For the reviewer, though, it is the points of disagreement that are the most interesting, and it is to those I now turn, minor though they are in comparison.

It is, I think, a great strength of the book that it starts with monopolistic competition — firms with some price setting power, but still constrained by rivals, rather than the pedagogically more common (but empirically less so) extremes of pure natural monopoly or perfect competition. Yet the full implications of this pervasive market structure are not fully appreciated. At the end of the second chapter, good price discrimination which expands the size of the market (selling retroviral drugs to the Third World at close to marginal cost) is contrasted with bad price discrimination which merely redistributes goods from high to low value consumers (granting student concessions on public transport). Leaving aside the empirical question of whether full fare commuters have self evidently more price elastic demand than First World AIDS patients or concession travellers, there is the unexamined assumption that a single fare would allow the service to be profitable enough to continue. The unavoidable dilemma whenever there is some fixed cost and marginal costs do not increase with output is that the efficient, marginal cost price loses money, while any increase in price is inefficient. Successful price discrimination may therefore determine whether the product exists at all, not just whether the quantity provided is marginally more or less efficient. This dilemma is never squarely faced, unlike the problems posed by externalities and imperfect information. In 'Perfect Markets' it is simply stated that marginal cost price is efficient. This could not be applied to most sectors of the economy without a vast system of subsidies and restrictions on entry.

Aside from fixed costs, one of the very few areas of basic microeconomics neglected by Harford is the classification of goods based on rivalry and excludability. This may be asking too much of a work that, after all, does not claim to be a textbook. Yet claiming that 'the basic rules for making money in the high-tech business are not so different from the rules for train operators or coffee bars' does not seem quite satisfactory. Although the concepts marginal cost and revenue are the same, and Hartford allows that the cost structures are different due to high R&D and low manufacturing costs, the combination of low rivalry in the intellectual property and low excludability thanks to easy piracy makes the software, pharmaceutical and music industries more different than he admits, and less susceptible to even a second-best market solution. Similarly, lumping police and schools together when considering government versus private provision is rather crude.

One piece of terminology is also unfortunate. As if the word 'monopoly' is to be avoided at any cost, 'scarcity power' is used instead, which indiscriminately

covers cases of natural scarcity such as good crop land, differences in the efficiency of organizations (which are rather confusingly also called ‘natural’), contrived monopolies through government regulation or criminal violence, or simply skills that are in short supply.

Yet with these reservations, *The Undercover Economist* is still superb. If I had to recommend a single book to introduce a non-economist to the field, or for a lecturer about to teach first year micro, I could not think of a better.

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