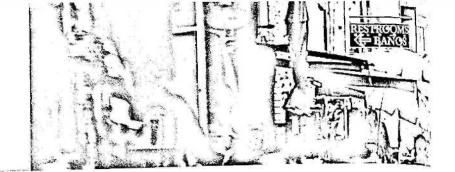
# Comtemits



Preface: To the Instructor v
Preface: To the Student xxxi

### PART I Introduction 1

### **CHAPTER 1**

### Ten Principles of Economics 1

1-1 How People Make Decisions 2

1-1a Principle 1: People Face Trade-Offs 2

1-1b Principle 2: The Cost of Something Is What You Give Up to Get It 3

1-1c Principle 3: Rational People Think at the Margin 4

1-1d Principle 4: People Respond to Incentives 5

1-2 How People Interact 6

1-2a Principle 5: Trade Can Make Everyone Better Off 7

1-2b Principle 6: Markets Are Usually a Good Way to Organize Economic Activity 7

FYI: Adam Smith and the Invisible Hand 8

CASE STUDY: Adam Smith Would Have Loved Uber 9

1-2c Principle 7: Governments Can Sometimes Improve Market Outcomes 9

1-3 How the Economy as a Whole Works 11

1-3a Principle 8: A Country's Standard of Living Depends on Its Ability to Produce Goods and Services 11

1-3b Principle 9: Prices Rise When the Government Prints Too Much Money 11

1-3c Principle 10: Society Faces a Short-Run Trade-Off between Inflation and Unemployment 12

1-4 Conclusion 13
Chapter in a Nutshell 14
Key Concepts 14
Questions for Review 14
Problems and Applications 14
Quick Quiz Answers 15

### **CHAPTER 2**

### Thinking Like an Economist 17

2-1 The Economist as Scientist 18

2-1a The Scientific Method: Observation, Theory, and More Observation 18

2-1b The Role of Assumptions 19

2-1c Economic Models 19

xviii

2-1d Our First Model: The Circular-Flow Diagram 20
2-1e Our Second Model: The Production Possibilities Frontier 21

2-1f Microeconomics and Macroeconomics 24

2-2 The Economist as Policy Adviser 25

2-2a Positive versus Normative Analysis 25

IN THE NEWS: Why Tech Companies Hire Economists 26

2-2b Economists in Washington 27

2-2c Why Economists' Advice Is Not Always Followed 28

2-3 Why Economists Disagree 29

2-3a Differences in Scientific Judgments 29

2-3b Differences in Values 30

2-3c Perception versus Reality 30

ASK THE EXPERTS: Ticket Resale 32

2-4 Let's Get Going 32

Chapter in a Nutshell 33

Key Concepts 33

Questions for Review 33

Problems and Applications 34

Quick Quiz Answers 34

APPENDIX Graphing: A Brief Review 35

Graphs of a Single Variable 35

Graphs of Two Variables: The Coordinate System 36

Curves in the Coordinate System 37

Slope 39

Cause and Effect 41

### **CHAPTER 3**

# Interdependence and the Gains from Trade 45

### 3-1 A Parable for the Modern Economy 46

3-1a Production Possibilities 46

3-1b Specialization and Trade 48

### 3-2 Comparative Advantage: The Driving Force of Specialization 50

3-2a Absolute Advantage 50

3-2b Opportunity Cost and Comparative Advantage 50

3-2c Comparative Advantage and Trade 52

3-2d The Price of the Trade 52

FYI: The Legacy of Adam Smith and David Ricardo 53

### 3-3 Applications of Comparative Advantage 54

3-3a Should LeBron James Mow His Own Lawn? 54

3-3b Should the United States Trade with Other Countries? 54

3-4 Conclusion 55

**ASK THE EXPERTS:** Trade between China and the United States 55

**IN THE NEWS:** Economics within a Marriage 56

Chapter in a Nutshell 56 Key Concepts 57 Questions for Review 57 Problems and Applications 58 Quick Quiz Answers 59

### **PART II** How Markets Work 61

### CHAPTER 4

### The Market Forces of Supply and Demand 61

### 4-1 Markets and Competition 62

4-1a What Is a Market? 62

4-1b What Is Competition? 62

#### 4-2 Demand 63

4-2a The Demand Curve: The Relationship between Price and Quantity Demanded 63

4-2b Market Demand versus Individual Demand 64

4-2c Shifts in the Demand Curve 65

**CASE STUDY:** Two Ways to Reduce Smoking 68

### 4-3 Supply 69

4-3a The Supply Curve: The Relationship between Price and Quantity Supplied 69

4-3b Market Supply versus Individual Supply 70

4-3c Shifts in the Supply Curve 71

### 4-4 Supply and Demand Together 73

4-4a Equilibrium 73

4-4b Three Steps to Analyzing Changes in Equilibrium 75 IN THE NEWS: Price Increases after Disasters 80

4-5 Conclusion: How Prices Allocate Resources 81 **ASK THE EXPERTS:** Price Gouging 82

Chapter in a Nutshell 82 Key Concepts 83 Questions for Review 83 Problems and Applications 84 Quick Quiz Answers 85

### CHAPTER 5

### Elasticity and Its Application 87

### 5-1 The Elasticity of Demand 88

5-1a The Price Elasticity of Demand and Its Determinants 88

5-1b Computing the Price Elasticity of Demand 89

5-1c The Midpoint Method: A Better Way to Calculate Percentage Changes and Elasticities 90

5-1d The Variety of Demand Curves 91

FYI: A Few Elasticities from the Real World 91

5-1e Total Revenue and the Price Elasticity of Demand 93

5-1f Elasticity and Total Revenue along a Linear Demand Curve 94

5-1g Other Demand Elasticities 96

### 5-2 The Elasticity of Supply 97

5-2a The Price Elasticity of Supply and Its Determinants 97

5-2b Computing the Price Elasticity of Supply 98

5-2c The Variety of Supply Curves 98

### 5-3 Three Applications of Supply, Demand, and Elasticity 100

5-3a Can Good News for Farming Be Bad News for Farmers? 101

5-3b Why Did OPEC Fail to Keep the Price of Oil High? 103

5-3c Does Drug Interdiction Increase or Decrease Drug-Related Crime? 104

5-4 Conclusion 106

Chapter in a Nutshell 106

Key Concepts 107

Questions for Review 107

Problems and Applications 107

Quick Quiz Answers 108

### CHAPTER 6

### Supply, Demand, and Government Policies 109

#### 6-1 Controls on Prices 110

6-1a How Price Ceilings Affect Market Outcomes 110

**CASE STUDY:** Lines at the Gas Pump 112

CASE STUDY: Rent Control in the Short Run and the Long Run 113

**ASK THE EXPERTS:** Rent Control 114

6-1b How Price Floors Affect Market Outcomes 114

**CASE STUDY:** The Minimum Wage 116

ASK THE EXPERTS: The Minimum Wage 117

6-1c Evaluating Price Controls 118

#### 6-2 Taxes 119

6-2a How Taxes on Sellers Affect Market Outcomes 119

**IN THE NEWS:** Should the Minimum Wage

Be \$15 an Hour? 120

6-2b How Taxes on Buyers Affect Market Outcomes 122

**CASE STUDY:** Can Congress Distribute the Burden of a Payroll Tax? 124

6-2c Elasticity and Tax Incidence 125

**CASE STUDY:** Who Pays the Luxury Tax? 126

6-3 Conclusion 127

Chapter in a Nutshell 127

Key Concepts 128

Questions for Review 128

Problems and Applications 128

Quick Quiz Answers 130

# PART III Markets and Welfare 131

### CHAPTER 7

## Consumers, Producers, and the Efficiency of Markets 131

7-1 Consumer Surplus 132

7-1a Willingness to Pay 132

7-1b Using the Demand Curve to Measure

Consumer Surplus 133

7-1c How a Lower Price Raises Consumer Surplus 134

7-1d What Does Consumer Surplus Measure? 135

7-2 Producer Surplus 137

7-2a Cost and the Willingness to Sell 137

7-2b Using the Supply Curve to Measure Producer Surplus 138

7-2c How a Higher Price Raises Producer Surplus 140

7-3 Market Efficiency 141

7-3a The Benevolent Social Planner 141

7-3b Evaluating the Market Equilibrium 142

CASE STUDY: Should There Be a Market

for Organs? 145

**ASK THE EXPERTS:** Supplying Kidneys 145

IN THE NEWS: How Ticket Resellers Help Allocate

Scarce Resources 146

7-4 Conclusion: Market Efficiency and Market Failure 147

Chapter in a Nutshell 148

Key Concepts 148

Questions for Review 149

Problems and Applications 149

Quick Quiz Answers 150

### CHAPTER 8

### **Application: The Costs of Taxation 151**

8-1 The Deadweight Loss of Taxation 152

8-1a How a Tax Affects Market Participants 152

8-1b Deadweight Losses and the Gains from Trade 155

8-2 The Determinants of the Deadweight Loss 157

CASE STUDY: The Deadweight Loss Debate 158

8-3 Deadweight Loss and Tax Revenue as Taxes Vary 160

**CASE STUDY:** The Laffer Curve and Supply-Side Economics 161

ASK THE EXPERTS: The Laffer Curve 162

8-4 Conclusion 163

Chapter in a Nutshell 163

Key Concept 164

Questions for Review 164

Problems and Applications 164

Quick Quiz Answers 165

### CHAPTER 9

### **Application: International Trade** 167

9-1 The Determinants of Trade 168

9-1a The Equilibrium without Trade 168

9-1b The World Price and Comparative Advantage 169

9-2 The Winners and Losers from Trade 170

9-2a The Gains and Losses of an Exporting Country 170

9-2b The Gains and Losses of an Importing Country 171

9-2c The Effects of a Tariff 173

FYI: Import Quotas: Another Way to Restrict Trade 175

9-2d The Lessons for Trade Policy 175

9-2e Other Benefits of International Trade 176

IN THE NEWS: Trade as a Tool for Economic Development 178

### 9-3 The Arguments for Restricting Trade 178

9-3a The Jobs Argument 178

9-3b The National-Security Argument 179

9-3c The Infant-Industry Argument 180

9-3d The Unfair-Competition Argument 180

9-3e The Protection-as-a-Bargaining-Chip Argument 180

CASE STUDY: Trade Agreements and the World Trade
Organization 181

ASK THE EXPERTS: Tariffs and Trade Deals 181

IN THE NEWS: The Trade Policies of

President Trump 182

9-4 Conclusion 183

Chapter in a Nutshell 184

Key Concepts 184

Questions for Review 185

Problems and Applications 185

Quick Quiz Answers 186

### PART IV The Economics of the Public Sector 187

### CHAPTER 10

### Externalities 187

### .....

10-1 Externalities and Market Inefficiency 189

10-1a Welfare Economics: A Recap 189

10-1b Negative Externalities 190

10-1c Positive Externalities 191

**CASE STUDY:** Technology Spillovers, Industrial Policy, and Patent Protection 192

### 10-2 Public Policies toward Externalities 193

10-2a Command-and-Control Policies: Regulation 193

**ASK THE EXPERTS:** Vaccines 194

10-2b Market-Based Policy 1: Corrective Taxes and Subsidies 194

**CASE STUDY:** Why Is Gasoline Taxed So Heavily? 195 10-2c Market-Based Policy 2: Tradable Pollution Permits 197

IN THE NEWS: What Should We Do about Climate Change? 198

**ASK THE EXPERTS:** Carbon Taxes 200 10-2d Objections to the Economic Analysis of Pollution 200

### 10-3 Private Solutions to Externalities 201

10-3a The Types of Private Solutions 201

10-3b The Coase Theorem 202

10-3c Why Private Solutions Do Not Always Work 203

IN THE NEWS: The Coase Theorem in Action 204

10-4 Conclusion 204
Chapter in a Nutshell 205
Key Concepts 206
Questions for Review 206
Problems and Applications 206
Quick Quiz Answers 207

### CHAPTER 11

### Public Goods and Common Resources 209

### 11-1 The Different Kinds of Goods 210

#### 11-2 Public Goods 212

11-2a The Free-Rider Problem 212 11-2b Some Important Public Goods 213 **CASE STUDY:** Are Lighthouses Public Goods? 214 11-2c The Difficult Job of Cost–Benefit Analysis 215

**CASE STUDY:** How Much Is a Life Worth? 215

#### 11-3 Common Resources 217

11-3a The Tragedy of the Commons 217
11-3b Some Important Common Resources 218
ASK THE EXPERTS: Congestion Pricing 218
CASE STUDY: Why the Cow Is Not Extinct 219
IN THE NEWS: Social Media as a Common Resource 220

11-4 Conclusion: The Importance of Property Rights 221 Chapter in a Nutshell 222

Key Concepts 222
Questions for Review 222
Problems and Applications 223
Quick Quiz Answers 224

### CHAPTER 12

### The Design of the Tax System 225

### 12-1 An Overview of U.S. Taxation 226

12-1a Taxes Collected by the Federal Government 227 12-1b Taxes Collected by State and Local Governments 229

### 12-2 Taxes and Efficiency 230

12-2a Deadweight Losses 231

**CASE STUDY:** Should Income or Consumption

Be Taxed? 231

12-2b Administrative Burden 232

12-2c Marginal Tax Rates versus Average Tax Rates 233 12-2d Lump-Sum Taxes 233

**ASK THE EXPERTS:** Top Marginal Tax Rates 233

### 12-3 Taxes and Equity 234

12-3a The Benefits Principle 235 12-3b The Ability-to-Pay Principle 235

CASE STUDY: How the Tax Burden Is Distributed 236

12-3c Tax Incidence and Tax Equity 238

CASE STUDY: Who Pays the Corporate

Income Tax? 238

### 12-4 Conclusion: The Trade-Off between Equity

and Efficiency 239
Chapter in a Nutshell 240

Chapter in a Nutshell 240

Key Concepts 240

Questions for Review 240

Problems and Applications 241

Quick Quiz Answers 241

### PART V Firm Behavior and the Organization of Industry 243

### CHAPTER 13

### The Costs of Production 243

### 13-1 What Are Costs? 244

13-1a Total Revenue, Total Cost, and Profit 244

13-1b Costs as Opportunity Costs 244

13-1c The Cost of Capital as an Opportunity Cost 245

13-1d Economic Profit versus Accounting Profit 246

#### 13-2 Production and Costs 247

13-2a The Production Function 247

13-2b From the Production Function to the Total-Cost Curve 249

### 13-3 The Various Measures of Cost 250

13-3a Fixed and Variable Costs 251

13-3b Average and Marginal Cost 251

13-3c Cost Curves and Their Shapes 252

13-3d Typical Cost Curves 254

### 13-4 Costs in the Short Run and in the Long Run 256

13-4a The Relationship between Short-Run and Long-Run Average Total Cost 256

13-4b Economies and Diseconomies of Scale 257

FYI: Lessons from a Pin Factory 258

#### 13-5 Conclusion 258

Chapter in a Nutshell 259

Key Concepts 260

Questions for Review 260

Problems and Applications 260

Quick Quiz Answers 262

### CHAPTER 14

### Firms in Competitive Markets 263

### 14-1 What Is a Competitive Market? 264

14-1a The Meaning of Competition 264

14-1b The Revenue of a Competitive Firm 264

### 14-2 Profit Maximization and the Competitive Firm's Supply Curve 266

14-2a A Simple Example of Profit Maximization 266

14-2b The Marginal-Cost Curve and the Firm's Supply Decision 268

14-2c The Firm's Short-Run Decision to Shut Down 270

14-2d Spilt Milk and Other Sunk Costs 271

CASE STUDY: Near-Empty Restaurants and Off-Season Miniature Golf 272

14-2e The Firm's Long-Run Decision to Exit or Enter a Market 272

14-2f Measuring Profit in Our Graph for the Competitive Firm 274

14-2g A Brief Recap 275

### 14-3 The Supply Curve in a Competitive Market 276

14-3a The Short Run: Market Supply with a Fixed Number of Firms 276

14-3b The Long Run: Market Supply with Entry and Exit 276

14-3c Why Do Competitive Firms Stay in Business If They Make Zero Profit? 278

14-3d A Shift in Demand in the Short Run and Long Run 279

14-3e Why the Long-Run Supply Curve Might Slope Upward 279

### 14-4 Conclusion: Behind the Supply Curve 281

Chapter in a Nutshell 282

Key Concepts 282

Questions for Review 282

Problems and Applications 283

Quick Quiz Answers 285

#### CHAPTER 15

### Monopoly 287

#### 15-1 Why Monopolies Arise 288

15-1a Monopoly Resources 289

15-1b Government-Created Monopolies 289

15-1c Natural Monopolies 290

### 15-2 How Monopolies Make Production and Pricing Decisions 291

15-2a Monopoly versus Competition 291

15-2b A Monopoly's Revenue 292

15-2c Profit Maximization 294

15-2d A Monopoly's Profit 296

FYI: Why a Monopoly Does Not Have a Supply Curve 297 CASE STUDY: Monopoly Drugs versus Generic Drugs 297

### 15-3 The Welfare Cost of Monopolies 299

15-3a The Deadweight Loss 299

15-3b The Monopoly's Profit: A Social Cost? 301

### 15-4 Price Discrimination 302

15-4a A Parable about Pricing 302

15-4b The Moral of the Story 303

15-4c The Analytics of Price Discrimination 304

15-4d Examples of Price Discrimination 305

IN THE NEWS: Price Discrimination Reaches the Supreme Court 306

### 15-5 Public Policy toward Monopolies 308

15-5a Increasing Competition with Antitrust Laws 308

15-5b Regulation 309

### ASK THE EXPERTS: Mergers 310

15-5c Public Ownership 310

15-5d Doing Nothing 311

### 15-6 Conclusion: The Prevalence of Monopolies 311

Chapter in a Nutshell 312

Key Concepts 313

Questions for Review 313

Problems and Applications 313

Quick Quiz Answers 316

### CHAPTER 16

### **Monopolistic Competition 317**

### 16-1 Between Monopoly and Perfect Competition 318

#### 16-2 Competition with Differentiated Products 320

16-2a The Monopolistically Competitive Firm in the Short Run 320

16-2b The Long-Run Equilibrium 322

16-2c Monopolistic versus Perfect Competition 323

16-2d Monopolistic Competition and the Welfare of Society 324

#### 16-3 Advertising 326

16-3a The Debate over Advertising 326

**CASE STUDY:** How Advertising Affects Prices 327

16-3b Advertising as a Signal of Quality 328

16-3c Brand Names 329

### 16-4 Conclusion 331

Chapter in a Nutshell 332

Key Concepts 332

Questions for Review 332

Problems and Applications 332

Quick Quiz Answers 333

#### CHAPTER 17

### Oligopoly 335

### 17-1 Markets with Only a Few Sellers 336

17-1a A Duopoly Example 336

17-1b Competition, Monopolies, and Cartels 336

17-1c The Equilibrium for an Oligopoly 338

17-1d How the Size of an Oligopoly Affects the Market Outcome 339

ASK THE EXPERTS: Market Share and Market Power 340

### 17-2 The Economics of Cooperation 341

17-2a The Prisoners' Dilemma 341

17-2b Oligopolies as a Prisoners' Dilemma 342

**CASE STUDY:** OPEC and the World Oil Market 343

17-2c Other Examples of the Prisoners' Dilemma 344

17-2d The Prisoners' Dilemma and the Welfare of Society 345

17-2e Why People Sometimes Cooperate 346

**CASE STUDY:** The Prisoners' Dilemma Tournament 346

### 17-3 Public Policy toward Oligopolies 347

17-3a Restraint of Trade and the Antitrust Laws 347

CASE STUDY: An Illegal Phone Call 348

17-3b Controversies over Antitrust Policy 349

CASE STUDY: The Microsoft Case 351

**IN THE NEWS:** Is Amazon the Next Antitrust Target? 352

#### 17-4 Conclusion 353

Chapter in a Nutshell 354

Key Concepts 354

Questions for Review 354

Problems and Applications 354

Quick Quiz Answers 356

### PART VI The Economics of Labor Markets 357

### CHAPTER 18

# The Markets for the Factors of Production 357

### 18-1 The Demand for Labor 358

18-1a The Competitive Profit-Maximizing Firm 358

18-1b The Production Function and the Marginal Product of Labor 359

18-1c The Value of the Marginal Product and the Demand for Labor 361

18-1d What Causes the Labor-Demand Curve to Shift? 362

**<u>FYI:</u>** Input Demand and Output Supply: Two Sides of the Same Coin 363

### 18-2 The Supply of Labor 364

18-2a The Trade-Off between Work and Leisure 364 18-2b What Causes the Labor-Supply Curve to Shift? 365

### 18-3 Equilibrium in the Labor Market 366

ASK THE EXPERTS: Immigration 366

18-3a Shifts in Labor Supply 366

18-3b Shifts in Labor Demand 368

CASE STUDY: Productivity and Wages 369

FYI: Monopsony 370

### 18-4 The Other Factors of Production: Land and Capital 370

18-4a Equilibrium in the Markets for Land and Capital 371

FYI: What Is Capital Income? 372

18-4b Linkages among the Factors of Production 372

CASE STUDY: The Economics of the Black Death 373

IN THE NEWS: The Winners and Losers from

Immigration 374

18-5 Conclusion 374

Chapter in a Nutshell 376

Key Concepts 376

Questions for Review 376

Problems and Applications 376

Quick Quiz Answers 378

### CHAPTER 19

### Earnings and Discrimination 379

### 19-1 Some Determinants of Equilibrium Wages 380

19-1a Compensating Differentials 380

19-1b Human Capital 380

**CASE STUDY:** The Increasing Value of Skills 381

**ASK THE EXPERTS:** Inequality and Skills 382

19-1c Ability, Effort, and Chance 382

CASE STUDY: The Benefits of Beauty 383

19-1d An Alternative View of Education: Signaling 383

19-1e The Superstar Phenomenon 384

19-1f Above-Equilibrium Wages: Minimum-Wage Laws, Unions, and Efficiency Wages 385

IN THE NEWS: Schooling as a Public Investment 386

### 19-2 The Economics of Discrimination 387

19-2a Measuring Labor-Market Discrimination 387

CASE STUDY: Is Emily More Employable than Lakisha? 389

19-2b Discrimination by Employers 389

CASE STUDY: Segregated Streetcars and the Profit Motive 390

19-2c Discrimination by Customers and Governments 391

CASE STUDY: Discrimination in Sports 391

19-2d Statistical Discrimination 392

19-3 Conclusion 393

Chapter in a Nutshell 394

Key Concepts 394

Questions for Review 394

Problems and Applications 395

Quick Quiz Answers 395

### CHAPTER 20

### **Income Inequality and Poverty** 397

### 20-1 Measuring Inequality 398

20-1a U.S. Income Inequality 398

20-1b Inequality Around the World 399

**FYI:** Incomes of the Super-Rich 400

20-1c The Poverty Rate 400

20-1d Problems in Measuring Inequality 403

IN THE NEWS: Are We Winning the War on Poverty? 404

**CASE STUDY:** Alternative Measures of Inequality 404

20-1e Economic Mobility 405

#### 20-2 The Political Philosophy of Redistributing Income 406

20-2a Utilitarianism 407

20-2b Liberalism 408

20-2c Libertarianism 409

### 20-3 Policies to Reduce Poverty 410

20-3a Minimum-Wage Laws 410

20-3b Welfare 411

20-3c Negative Income Tax 411

20-3d In-Kind Transfers 412

20-3e Antipoverty Programs and Work Incentives 413

IN THE NEWS: International Differences in Income Redistribution 414

20-4 Conclusion 416

Chapter in a Nutshell 416

Key Concepts 416

Questions for Review 417

Problems and Applications 417

Quick Quiz Answers 418

### PART VII Topics for Further Study 419

### CHAPTER 21

### The Theory of Consumer Choice 419

### 21-1 The Budget Constraint: What a Consumer Can Afford 420

21-1a Representing Consumption Opportunities in a Graph 420

21-1b Shifts in the Budget Constraint 421

### 21-2 Preferences: What a Consumer Wants 423

21-2a Representing Preferences with Indifference Curves 423

21-2b Four Properties of Indifference Curves 424

21-2c Two Extreme Examples of Indifference Curves 426

#### 21-3 Optimization: What a Consumer Chooses 428

21-3a The Consumer's Optimal Choices 428

21-3b How Changes in Income Affect the

Consumer's Choices 429

FYI: Utility: An Alternative Way to Describe Preferences and Optimization 430

21-3c How Changes in Prices Affect the Consumer's Choices 430

21-3d Income and Substitution Effects 432

21-3e Deriving the Demand Curve 433

#### 21-4 Three Applications 435

21-4a Do All Demand Curves Slope Downward? 435

CASE STUDY: The Search for Giffen Goods 436

21-4b How Do Wages Affect Labor Supply? 436

**CASE STUDY:** Income Effects on Labor Supply: Historical Trends, Lottery Winners, and the Carnegie Conjecture 439

21-4c How Do Interest Rates Affect Household Saving? 440

### 21-5 Conclusion: Do People Really Think This Way? 443

Chapter in a Nutshell 443

Key Concepts 444

Questions for Review 444

Problems and Applications 444

Quick Quiz Answers 445

### CHAPTER 22

### Frontiers of Microeconomics 447

### 22-1 Asymmetric Information 448

22-1a Hidden Actions: Principals, Agents, and Moral Hazard 448

FYI: Corporate Management 449

22-1b Hidden Characteristics: Adverse Selection and the

Lemons Problem 450

22-1c Signaling to Convey Private Information 450

CASE STUDY: Gifts as Signals 451

22-1d Screening to Uncover Private Information 452

22-1e Asymmetric Information and Public Policy 452

### 22-2 Political Economy 453

22-2a The Condorcet Voting Paradox 453

22-2b Arrow's Impossibility Theorem 454

22-2c The Median Voter Is King 455

22-2d Politicians Are People Too 457

### 22-3 Behavioral Economics 458

22-3a People Aren't Always Rational 458

22-3b People Care about Fairness 459

22-3c People Are Inconsistent over Time 460

ASK THE EXPERTS: Behavioral Economics 461

IN THE NEWS: Using Deviations from Rationality 462

#### 22-4 Conclusion 464

Chapter in a Nutshell 464

Key Concepts 464

Questions for Review 465

Problems and Applications 465

Quick Quiz Answers 466

### PART VIII The Data of Macroeconomics 467

### CHAPTER 23

### Measuring a Nation's Income 467

### 23-1 The Economy's Income and Expenditure 468

### 23-2 The Measurement of GDP 470

23-2a "GDP Is the Market Value ..." 470

23-2b "... of All ... " 470

23-2c "...Final..." 471

23-2d "...Goods and Services..." 471

23-2e "... Produced ... " 471

23-2f "...Within a Country..." 471

23-2g "...In a Given Period of Time." 471

**FYI:** Other Measures of Income 472

### 23-3 The Components of GDP 473

23-3a Consumption 473

23-3b Investment 473

23-3c Government Purchases 474

23-3d Net Exports 474

CASE STUDY: The Components of U.S. GDP 475

### 23-4 Real versus Nominal GDP 476

23-4a A Numerical Example 476 23-4b The GDP Deflator 477

CASE STUDY: A Half Century of Real GDP 478

### 23-5 Is GDP a Good Measure of Economic Well-Being? 480

CASE STUDY: International Differences in GDP and the Ouality of Life 481

IN THE NEWS: Sex, Drugs, and GDP 482

23-6 Conclusion 483 Chapter in a Nutshell 484

Key Concepts 484

Questions for Review 484 Problems and Applications 484

Quick Quiz Answers 486

### CHAPTER 24

### Measuring the Cost of Living 487

### 24-1 The Consumer Price Index 488

24-1a How the CPI Is Calculated 488

**FYI:** What's in the CPI's Basket? 490

24-1b Problems in Measuring the Cost of Living 491

24-1c The GDP Deflator versus the Consumer Price Index 492

### 24-2 Correcting Economic Variables for the Effects

of Inflation 494

24-2a Dollar Figures from Different Times 494

**FYI:** Mr. Index Goes to Hollywood 495

**CASE STUDY:** Regional Differences in the Cost of Living 495

24-2b Indexation 497

24-2c Real and Nominal Interest Rates 497

CASE STUDY: Interest Rates in the U.S. Economy 499

24-3 Conclusion 500

Chapter in a Nutshell 501

Key Concepts 501

Questions for Review 501

Problems and Applications 502

Quick Quiz Answers 503

### **PART IX** The Real Economy in the Long Run 505

### CHAPTER

### Production and Growth 505

### 25-1 Economic Growth around the World 506

FYI: Are You Richer Than the Richest American? 508

### 25-2 Productivity: Its Role and Determinants 508

25-2a Why Productivity Is So Important 509

25-2b How Productivity Is Determined 509

FYI: The Production Function 511

CASE STUDY: Are Natural Resources a Limit

to Growth? 512

### 25-3 Economic Growth and Public Policy 513

25-3a Saving and Investment 513

25-3b Diminishing Returns and the Catch-Up Effect 513

25-3c Investment from Abroad 515

25-3d Education 516

25-3e Health and Nutrition 516

25-3f Property Rights and Political Stability 517

25-3g Free Trade 518

25-3h Research and Development 519

**ASK THE EXPERTS:** Innovation and Growth 519

25-3i Population Growth 519

CASE STUDY: Why Is So Much of Africa Poor? 521

IN THE NEWS: The Secret Sauce of American

Prosperity 524

### 25-4 Conclusion: The Importance of Long-Run Growth 524

Chapter in a Nutshell 525

Key Concepts 526

Questions for Review 526

Problems and Applications 526

Quick Quiz Answers 527

### CHAPTER 26

### Saving, Investment, and the Financial System 529

### 26-1 Financial Institutions in the U.S. Economy 530

26-1a Financial Markets 530

26-1b Financial Intermediaries 532

26-1c Summing Up 534

#### 26-2 Saving and Investment in the National Income Accounts 534

26-2a Some Important Identities 535

26-2b The Meaning of Saving and Investment 536

#### 26-3 The Market for Loanable Funds 537

26-3a Supply and Demand for Loanable Funds 537

26-3b Policy 1: Saving Incentives 539

26-3c Policy 2: Investment Incentives 541

26-3d Policy 3: Government Budget Deficits and Surpluses 542

**ASK THE EXPERTS:** Fiscal Policy and Saving 543

CASE STUDY: The History of U.S. Government Debt 544

FYI: Financial Crises 546

26-4 Conclusion 547

Chapter in a Nutshell 547

Key Concepts 547

Questions for Review 548

Problems and Applications 548

Quick Quiz Answers 549

### CHAPTER 27

### The Basic Tools of Finance 551

27-1 Present Value: Measuring the Time Value of Money 552 FYI: The Magic of Compounding and the Rule of 70 554

### 27-2 Managing Risk 554

27-2a Risk Aversion 555

27-2b The Markets for Insurance 555

27-2c Diversification of Firm-Specific Risk 556

27-2d The Trade-Off between Risk and Return 557

### 27-3 Asset Valuation 559

27-3a Fundamental Analysis 559

FYI: Key Numbers for Stock Watchers 560

27-3b The Efficient Markets Hypothesis 560

CASE STUDY: Random Walks and Index Funds 561

**ASK THE EXPERTS:** Diversified Investing 562

27-3c Market Irrationality 562

27-4 Conclusion 563

Chapter in a Nutshell 563

Key Concepts 564

Questions for Review 564

Problems and Applications 564

Quick Quiz Answers 565

### CHAPTER 28

### Unemployment 567

### 28-1 Identifying Unemployment 568

28-1a How Is Unemployment Measured? 568

CASE STUDY: Labor-Force Participation of Men and

Women in the U.S. Economy 571

28-1b Does the Unemployment Rate Measure What We

Want It to Measure? 572

28-1c How Long Are the Unemployed without Work? 574

28-1d Why Are There Always Some People Unemployed? 574 **FYI:** The Jobs Number 575

28-2 Job Search 576

28-2a Why Some Frictional Unemployment

Is Inevitable 576

28-2b Public Policy and Job Search 576

28-2c Unemployment Insurance 577

28-3 Minimum-Wage Laws 578

CASE STUDY: Who Earns the Minimum Wage? 579

### 28-4 Unions and Collective Bargaining 581

28-4a The Economics of Unions 581

28-4b Are Unions Good or Bad for the Economy? 582

### 28-5 The Theory of Efficiency Wages 583

28-5a Worker Health 583

28-5b Worker Turnover 584

28-5c Worker Quality 584

28-5d Worker Effort 584

CASE STUDY: Henry Ford and the Very Generous

\$5-a-Day Wage 585

28-6 Conclusion 586

Chapter in a Nutshell 586

Key Concepts 587

Questions for Review 587

Problems and Applications 587

Quick Quiz Answers 588

# PART X Money and Prices in the Long Run 589

### CHAPTER 29

### The Monetary System 589

### 29-1 The Meaning of Money 590

29-1a The Functions of Money 590

29-1b The Kinds of Money 591

**FYI:** Cryptocurrencies: A Fad or the Future? 592

29-1c Money in the U.S. Economy 593

FYI: Why Credit Cards Aren't Money 594

CASE STUDY: Where Is All the Currency? 594

### 29-2 The Federal Reserve System 595

29-2a The Fed's Organization 595

29-2b The Federal Open Market Committee 596

### 29-3 Banks and the Money Supply 597

29-3a The Simple Case of 100-Percent-Reserve Banking 597

29-3b Money Creation with Fractional-Reserve Banking 598

29-3c The Money Multiplier 599

29-3d Bank Capital, Leverage, and the Financial Crisis of 2008–2009 600

### 29-4 The Fed's Tools of Monetary Control 602

29-4a How the Fed Influences the Ouantity of Reserves 602

29-4b How the Fed Influences the Reserve Ratio 604

29-4c Problems in Controlling the Money Supply 604

**CASE STUDY:** Bank Runs and the Money Supply 605

IN THE NEWS: A Trip to Jekyll Island 606

29-4d The Federal Funds Rate 606

### 29-5 Conclusion 608

Chapter in a Nutshell 609

Key Concepts 609

Questions for Review 609

Problems and Applications 610

Quick Quiz Answers 611

### CHAPTER 30

### Money Growth and Inflation 613

### 30-1 The Classical Theory of Inflation 614

30-1a The Level of Prices and the Value of Money 615

30-1b Money Supply, Money Demand, and Monetary Equilibrium 615

30-1c The Effects of a Monetary Injection 617

30-1d A Brief Look at the Adjustment Process 618

30-1e The Classical Dichotomy and Monetary Neutrality 619

30-1f Velocity and the Quantity Equation 620

**CASE STUDY:** Money and Prices during Four

Hyperinflations 622

30-1g The Inflation Tax 622

30-1h The Fisher Effect 624

### 30-2 The Costs of Inflation 626

30-2a A Fall in Purchasing Power? The Inflation Fallacy 626

30-2b Shoeleather Costs 627

30-2c Menu Costs 628

30-2d Relative-Price Variability and the Misallocation of Resources 628

30-2e Inflation-Induced Tax Distortions 629

30-2f Confusion and Inconvenience 630

30-2g A Special Cost of Unexpected Inflation: Arbitrary Redistributions of Wealth 631

30-2h Inflation Is Bad, but Deflation May Be Worse 631

**CASE STUDY:** The Wizard of Oz and the Free-Silver Debate 632

IN THE NEWS: Life During Hyperinflation 634

30-3 Conclusion 634 Chapter in a Nutshell 636 Key Concepts 636 Questions for Review 636 Problems and Applications 637 Quick Quiz Answers 637

# PART XI The Macroeconomics of Open Economies 639

### CHAPTER 31

# Open-Economy Macroeconomics: Basic Concepts 639

#### 31-1 The International Flows of Goods and Capital 640

31-1a The Flow of Goods: Exports, Imports, and Net Exports 640

**CASE STUDY:** The Increasing Openness of the U.S. Economy 641

31-1b The Flow of Financial Resources: Net Capital Outflow 642

31-1c The Equality of Net Exports and Net Capital Outflow 643

31-1d Saving, Investment, and Their Relationship to the International Flows 645

31-1e Summing Up 646

**CASE STUDY:** Is the U.S. Trade Deficit a National Problem? 647 **ASK THE EXPERTS:** Trade Balances and Trade

Negotiations 648

### 31-2 The Prices for International Transactions: Real and Nominal Exchange Rates 649

31-2a Nominal Exchange Rates 649

31-2b Real Exchange Rates 650

### **FYI:** The Euro 651

## 31-3 A First Theory of Exchange-Rate Determination: Purchasing-Power Parity 652

31-3a The Basic Logic of Purchasing-Power Parity 653 31-3b Implications of Purchasing-Power Parity 653

CASE STUDY: The Nominal Exchange Rate during a

Hyperinflation 655

31-3c Limitations of Purchasing-Power Parity 656 **CASE STUDY:** The Hamburger Standard 656

31-4 Conclusion 657 Chapter in a Nutshell 658 Key Concepts 658 Questions for Review 658 Problems and Applications 658 Quick Quiz Answers 659

### CHAPTER 32

### A Macroeconomic Theory of the Open Economy 661

### 32-1 Supply and Demand for Loanable Funds and for Foreign-Currency Exchange 662

32-1a The Market for Loanable Funds 662

32-1b The Market for Foreign-Currency Exchange 664

FYI: Purchasing-Power Parity as a Special Case 666

### 32-2 Equilibrium in the Open Economy 667

32-2a Net Capital Outflow: The Link between the Two Markets 667

32-2b Simultaneous Equilibrium in Two Markets 668 **FYI:** Disentangling Supply and Demand 670

### 32-3 How Policies and Events Affect an

### Open Economy 670

32-3a Government Budget Deficits 671

32-3b Trade Policy 673

**ASK THE EXPERTS:** Deficits 673

32-3c Political Instability and Capital Flight 675

**CASE STUDY:** Capital Flows from China 677

**IN THE NEWS:** Separating Fact from Fiction 678

**ASK THE EXPERTS:** Currency Manipulation 678

32-4 Conclusion 680

Chapter in a Nutshell 680

Key Concepts 681

Questions for Review 681

Problems and Applications 681

Quick Quiz Answers 682

# PART XII Short-Run Economic Fluctuations 683

### **CHAPTER 33**

# Aggregate Demand and Aggregate Supply 683

### 33-1 Three Key Facts about Economic Fluctuations 684

33-1a Fact 1: Economic Fluctuations Are Irregular and Unpredictable 684

33-1b Fact 2: Most Macroeconomic Quantities Fluctuate Together 686

33-1c Fact 3: As Output Falls, Unemployment Rises 686

### 33-2 Explaining Short-Run Economic Fluctuations 687

33-2a The Assumptions of Classical Economics 687

33-2b The Reality of Short-Run Fluctuations 687

33-2c The Model of Aggregate Demand and Aggregate Supply 688

### 33-3 The Aggregate-Demand Curve 689

33-3a Why the Aggregate-Demand Curve Slopes Downward 689

33-3b Why the Aggregate-Demand Curve Might Shift 692

### 33-4 The Aggregate-Supply Curve 695

33-4a Why the Aggregate-Supply Curve Is Vertical in the Long Run 695

33-4b Why the Long-Run Aggregate-Supply Curve Might Shift 696

33-4c Using Aggregate Demand and Aggregate Supply to Depict Long-Run Growth and Inflation 697

33-4d Why the Aggregate-Supply Curve Slopes Upward in the Short Run 699

33-4e Why the Short-Run Aggregate-Supply Curve Might Shift 702

### 33-5 Two Causes of Economic Fluctuations 704

33-5a The Effects of a Shift in Aggregate Demand 705

FYI: Monetary Neutrality Revisited 707

**CASE STUDY:** Two Big Shifts in Aggregate Demand: The Great Depression and World War II 707

**CASE STUDY:** The Great Recession of 2008–2009 709 33-5b The Effects of a Shift in Aggregate Supply 711

CASE\_STUDY: Oil and the Economy 713

**FYI:** The Origins of the Model of Aggregate Demand and Aggregate Supply 714

33-6 Conclusion 714

Chapter in a Nutshell 715

Key Concepts 715

Questions for Review 716

Problems and Applications 716

Quick Quiz Answers 717

### CHAPTER 34

# The Influence of Monetary and Fiscal Policy on Aggregate Demand 719

### 34-1 How Monetary Policy Influences Aggregate Demand 720

34-1a The Theory of Liquidity Preference 721

34-1b The Downward Slope of the Aggregate-Demand Curve 723

FYI: Interest Rates in the Long Run and the Short Run 724

34-1c Changes in the Money Supply 725

34-1d The Role of Interest-Rate Targets in Fed Policy 727

CASE STUDY: Why the Fed Watches the Stock Market
(and Vice Versa) 727

34-1e The Zero Lower Bound 728

### 34-2 How Fiscal Policy Influences Aggregate Demand 730

34-2a Changes in Government Purchases 730

34-2b The Multiplier Effect 730

34-2c A Formula for the Spending Multiplier 731

34-2d Other Applications of the Multiplier Effect 732

34-2e The Crowding-Out Effect 733

34-2f Changes in Taxes 734

FYI: How Fiscal Policy Might Affect

Aggregate Supply 735

### 34-3 Using Policy to Stabilize the Economy 736

34-3a The Case for Active Stabilization Policy 736

**CASE STUDY:** Keynesians in the White House 737

**ASK THE EXPERTS:** Economic Stimulus 737 IN THE NEWS: How Large Is the Fiscal

Policy Multiplier? 738

34-3b The Case against Active Stabilization Policy 739

34-3c Automatic Stabilizers 741

### 34-4 Conclusion 742

Chapter in a Nutshell 742

Key Concepts 743

Questions for Review 743

Problems and Applications 743

Quick Quiz Answers 744

### CHAPTER 35

# The Short-Run Trade-Off between Inflation and Unemployment 745

### 35-1 The Phillips Curve 746

35-1a Origins of the Phillips Curve 746

35-1b Aggregate Demand, Aggregate Supply, and the Phillips Curve 747

### 35-2 Shifts in the Phillips Curve: The Role of Expectations 749

35-2a The Long-Run Phillips Curve 749

35-2b The Meaning of "Natural" 751

35-2c Reconciling Theory and Evidence 752

35-2d The Short-Run Phillips Curve 753

35-2e The Natural Experiment for the Natural-Rate Hypothesis 754

## 35-3 Shifts in the Phillips Curve: The Role of Supply Shocks 756

### 35-4 The Cost of Reducing Inflation 759

35-4a The Sacrifice Ratio 759

35-4b Rational Expectations and the Possibility of Costless Disinflation 761

35-4c The Volcker Disinflation 762

35-4d The Greenspan Era 763

35-4e A Financial Crisis Takes Us for a Ride along the Phillips Curve 764

#### 35-5 Conclusion 766

Chapter in a Nutshell 766

Key Concepts 766

Questions for Review 767

Problems and Applications 767

Quick Quiz Answers 768

# PART XIII Final Thoughts 769

### **CHAPTER 36**

## Six Debates over Macroeconomic Policy 769

### 36-1 Should Monetary and Fiscal Policymakers Try to Stabilize the Economy? 770

- 36-1a Pro: Policymakers Should Try to Stabilize the Economy 770
- 36-1b Con: Policymakers Should Not Try to Stabilize the Economy 770

### 36-2 Should the Government Fight Recessions with Spending Hikes Rather Than Tax Cuts? 772

- 36-2a Pro: The Government Should Fight Recessions with Spending Hikes 772
- 36-2b Con: The Government Should Fight Recessions with Tax Cuts 773

### 36-3 Should Monetary Policy Be Made by Rule Rather Than by Discretion? 775

36-3a Pro: Monetary Policy Should Be Made by Rule 775 36-3b Con: Monetary Policy Should Not Be Made by Rule 776 FYI: Inflation Targeting 777

### 36-4 Should the Central Bank Aim for Zero Inflation? 778

- 36-4a Pro: The Central Bank Should Aim for Zero Inflation 778
- 36-4b Con: The Central Bank Should Not Aim for Zero Inflation 779

IN THE NEWS: A Central Bank Assesses Its Policy 780

### 36-5 Should the Government Balance Its Budget? 782

- 36-5a Pro: The Government Should Balance Its Budget 782
- 36-5b Con: The Government Should Not Balance Its Budget 783

### 36-6 Should the Tax Laws Be Reformed to Encourage Saving? 785

36-6a Pro: The Tax Laws Should Be Reformed to Encourage Saving 785

ASK THE EXPERTS: Taxing Capital and Labor 786
36-6b Con: The Tax Laws Should Not Be Reformed to
Encourage Saving 786

36-7 Conclusion 787
Chapter in a Nutshell 788
Questions for Review 788
Problems and Applications 789
Quick Quiz Answers 789