CONTENTS

PREFACE xix

PART I INTRODUCTION 1

	A MYTHYLDYG I WEL AN DOOMONION O
	1. THINKING LIKE AN ECONOMIST 3
	Scarcity and Choice 3 The Cost-Benefit Approach to Decisions 4
EXAMPLE 1.1	Should I turn down my stereo? 5 A Note on the Role of Economic Theory 6
	Some Common Pitfalls in Decision Making 7
	Should I go skiing or work as a research assistant? 7
EXAMPLE 1.2	Should I go skiing or scrape plates? 8
EXAMPLE 1.3	
EXAMPLE 1.4	After high school, should I work first or go to college first? 9
EXAMPLE 1.5	Is it fair to charge interest when lending a friend some money? 10
EXAMPLE 1.6	Why do banks pay interest in the first place? 10
EXAMPLE 1.7	Should I drive to Boston or take the bus? 12
EXAMPLE 1.8	The Pizza Experiment: how does an "all-you-can-cat" offer affect consumption? 13
EXAMPLE 1.9	Which is more important in a rental car for an energy-conservation minded consumer: better gas mileage or a cheaper rental rate? 14 The Invisible Hand 15
EXAMPLE 1.10	Should I burn my leaves or haul them into the woods? 16 Rationality and Self-Interest 17
EXAMPLE 1.11	Should I vote in the next presidential election? 18
	Would Parents Want Their Daughter or Son to Marry Homo Economicus? 19
	The Economic Naturalist 20
EXAMPLE 1.12	Why is airline food so bad? 20
EXAMPLE 1.13	Why do manual transmissions have five forward speeds, automatics only four? 21
EXAMPLE 1.14	Why have paper towels replaced hot-air hand dryers in public restrooms? 22
	Positive Questions and Normative Questions 23

EXAMPLE 2.3

EXAMPLE 2.4

EXAMPLE 3.2

Microeconomics and Macroeconomics 24

Summary 24

Questions for Review 25

Problems 25

Answers to In-Chapter Exercises 27

2. SUPPLY AND DEMAND 28

Chapter Preview 29

Supply and Demand Analysis 29

Equilibrium Quantity and Price 32

Some Welfare Properties of Equilibrium 35

Free Markets and the Poor 36

EXAMPLE 2.1 Is denied boarding compensation unfair to low-income passengers? 37

EXAMPLE 2.2 Rent controls 38

The Rationing and Allocative Functions of Prices 40

Determinants of Supply and Demand 41

Predicting and Explaining Changes in Price and Quantity 44

Why do the prices of apples go down during the months of heaviest consumption, while the prices of beachfront cottages go up? 44

Price Supports 44

How does a price support program in the soybean market affect the price and quantity of beef? 46

The Algebra of Supply and Demand 46

Taxes 47

Summary 51

Questions for Review 53

Problems 53

Answers to In-Chapter Exercises 55

PART II THE THEORY OF CONSUMER BEHAVIOR 57

3. RATIONAL CONSUMER CHOICE 59

Chapter Preview 59

The Opportunity Set or Budget Constraint 60

EXAMPLE 3.1 Quantity discount gives rise to a kinked budget constraint: graphing the budget constraint for a consumer's electrical power 66

Budget constraints following theft of gasoline or loss of cash: should Gowdy buy more gas? 67

Consumer Preferences 68

EXAMPLE 3.3 Graphing indifference curves for perfect substitutes: Jolt Cola vs. Coca-Cola 74

EXAMPLE 3.4 Graphing indifference curves for perfect complements: skis and bindings 75

ix

EXAMPLE 3.5 A neutral good: Eve likes apples but doesn't care about pears 77 When more of a good is worse: food vs. cigarette smoke 78 EXAMPLE 3.6 The Best Feasible Bundle 79 Equilibrium with perfect substitutes: Jolt Cola vs. Coca-Cola 83 EXAMPLE 3.7 An Application of the Rational Choice Model 83 EXAMPLE 3.8 Is it better to give poor people cash or food stamps? 84 Summary 87 APPENDIX: The Utility Function Approach to the Consumer **Budgeting Problem** 88 Cardinal versus Ordinal Utility 88 Generating Indifference Curves Algebraically 90 Using Calculus to Maximize Utility 91 Questions for Review 96 Problems 96 Answers to In-Chapter Exercises 99 4. INDIVIDUAL DEMAND 101 Chapter Preview 101 Effects of Changes in Price 102 Graphing price-consumption curves and demand curves for perfect EXAMPLE 4.1 substitutes: rice vs. wheat 104 The Effects of Changes in Income 105 Income and substitution effects for perfect complements: skis and EXAMPLE 4.2 bindings 110 Consumer Responsiveness to Changes in Price 112 The Income-Compensated Demand Curve 115 Consumer Surplus 117 What is the loss in consumer surplus from an oil price increase? 118 **EXAMPLE 4.3** Consumer surplus from eating at Pizza Hut 120 EXAMPLE 4.4 Overall Welfare Comparisons 122 Price changes: was Jones better off this year or last? 122 **EXAMPLE 4.5** Summary 122

APPENDIX: Cost-of-Living Indexes 124

EXAMPLE A.4.1 Cost of living changes with perfect substitutes: Smith's consumption in two different years 128

Questions for Review 129 Problems 130 Answers to In-Chapter Exercises 131 EXAMPLE 5.1

EXAMPLE 5.2

APPLICATION

APPLICATION

EXAMPLE 5.3

EXAMPLE 5.4 APPLICATION

5. MARKET DEMAND 134

Chapter Preview 134

Aggregating Individual Demand Curves 135

The market demand curve: beech saplings in a Vermont town 136

Price Elasticity of Demand 136

Price elasticity of demand: should the transit system raise or lower bus fares? 147

The MARTA Fare Increase 147

Determinants of Price Elasticity of Demand 148

The Price Elasticity of Demand for Alcohol 150

Why do National Football League games cost so much more than major league baseball games? 151

The Dependence of Market Demand on Income 152 How does income affect the market demand curve for food? 152

Forecasting Economic Trends 155

Cross-Price Elasticities of Demand 156

Cross-price elasticity: beef vs. chicken at your neighborhood supermarket 157

Summary 158

APPENDIX: The Constant Elasticity Demand Curve 160

Questions for Review 162

Problems 162

Answers to In-Chapter Exercises 164

6. INTERTEMPORAL CHOICE AND CHOICE UNDER UNCERTAINTY

(SUPPLEMENTARY) 165

Chapter Preview 165

The Intertemporal Choice Model 165

Will an increase in the interest rate cause you to save more? 172

The Permanent Income and Life-Cycle Hypotheses 172

Choice Under Uncertainty 179

Maximizing expected utility: Smith and gambling 181

Will you always accept a favorable bet? 183

Which of two colleges should you attend? 186

Always Self-Insure Against Small Losses 193

Summary 194

Problems 196

Answers to In-Chapter Exercises 198

7. BEYOND SELF-INTEREST? (SUPPLEMENTARY) 199

The Commitment Problem 200

The Reward Mechanism 202

EXAMPLE 5.5

EXAMPLE 6.1 APPLICATION

EXAMPLE 6.2

EXAMPLE 6.3

EXAMPLE 6.4

APPLICATION

The Problem of Mimicry 207

Illustration: The Cheating Problem 208

A Simple Thought Experiment 214

Tastes Not Only Can Differ; They Must Differ 215

APPLICATION

Altruistic Preferences 216

EXAMPLE 7.1

A utility-maximizing altruist: should Smith give some of his wealth to Jones? 217

APPLICATION

Concerns About Fairness 218

EXAMPLE 7.2

Will Hatfield and McCoy work together? 221

The Importance of Tastes 221

Summary 222

Questions for Review 223

Problems 223

Answers to In-Chapter Exercises 224

8. COGNITIVE LIMITATIONS AND CONSUMER BEHAVIOR

(SUPPLEMENTARY) 226

Chapter Preview 227

Bounded Rationality 227

The Asymmetric Value Function 229

Sunk Costs 231

Out-of-Pocket Costs Versus Opportunity Costs 232

Hedonic Framing 233

Choice Under Uncertainty 236

Judgmental Heuristics and Biases 239

The Psychophysics of Perception 244

The Difficulty of Actually Deciding 244

Summary 246

Questions for Review 248

Problems 249

Answer to In-Chapter Exercise 250

PART III THE THEORY OF THE FIRM AND MARKET STRUCTURE 251

9. PRODUCTION 253

Chapter Preview 253

The Input-Output Relationship, or Production Function 254

Production with One Variable Input 257

The Relationships Between Total, Marginal, and Average Product Curves 262

The Practical Significance of the Average-Marginal Distinction 264

EXAMPLE 9.1

Call's and McRae's ranch (I): how many cows should graze in each pasture? 265

EXAMPLE 9.2

Call's and McRae's ranch (II): now how many cows should graze in each pasture? 266

EXAMPLE 9.3

What is the optimal amount of time to spend on each exam question? 267

Production with Two Variable Inputs 267

Returns to Scale 271

Summary 274

APPENDIX: Mathematical Extensions of Production Theory 275

APPLICATION

The Average-Marginal Distinction 275 EXAMPLE A.9.1

Is the best football coach the one who always chooses the play that will gain the most yardage? 278

Isoquant Maps and the Production Mountain 279

Some Examples of Production Functions 280

A Mathematical Definition of Returns to Scale 282

Questions for Review 284

Problems 284

Answers to In-Chapter Exercises 286

10. COSTS 287

Chapter Preview 287

Costs in the Short Run 288

EXAMPLE 10.1

Graphing the total, variable, and fixed cost curves 294

EXAMPLE 10.2

Graphing the average and marginal cost curves 301

EXAMPLE 10.3

Allocating Production Between Two Processes 301 Using marginal and average total cost curves: finding the least costly production allocation 302

The Relationship Between MP, AP, MC, and AVC 303

Costs in the Long Run 304

EXAMPLE 10.4 APPLICATION

Why is gravel made by hand in Nepal, but by machine in the U.S.? 307 Unions and Minimum Wages 308

Long-Run Costs and the Structure of Industry 315

The Relationship Between Long-Run and Short-Run Cost Curves 317

Summary 321

APPENDIX: Mathematical Extensions of the Theory of Costs 322

Minimizing costs for a specific production function 323

Questions for Review 324

Problems 324

Answers to In-Chapter Exercises 326

EXAMPLE A.10.1

11. PERFECT COMPETITION 328

Chapter Preview 328

The Goal of Profit Maximization 329

EXAMPLE 11.1

Should the owner of Valdosta, Georgia's miniature golf course move the operation to Manhattan? 330

The Four Conditions for Perfect Competition 332

The Short-Run Condition for Profit Maximization 334

Short-Run Competitive Industry Supply 339

Short-Run Competitive Equilibrium 340

The Efficiency of Short-Run Competitive Equilibrium 342 Producer Surplus 343

EXAMPLE 11.2

Should the legislature ban fireworks? 346

Adjustments in the Long Run 347

The Invisible Hand 350

APPLICATION

The Cost of Extraordinary Inputs 352

The Long-Run Competitive Industry Supply Curve 354

EXAMPLE 11.3

Why do color photographs cost less than black and white photographs? 358

The Elasticity of Supply 358

Applying the Competitive Model 360

Summary 366

Questions for Review 367

Problems 367

Answers to In-Chapter Exercises 369

12. MONOPOLY 370

Chapter Preview 370

Defining Monopoly 371

Four Sources of Monopoly 372

The Profit-Maximizing Monopolist 375

EXAMPLE 12.1

EXAMPLE 12.2

Finding a marginal revenue curve for a given demand curve 383
What is a monopolist's profit-marinizing price, and how much

What is a monopolist's profit-maximizing price, and how much economic profit is earned? 384

A Monopolist Has No Supply Curve 387

Adjustments in the Long Run 388

The Output-Maximizing Monopolist 389

Multiplant Monopoly 390

Price Discrimination 391

The Efficiency Loss from Monopoly 397

Public Policy Toward Natural Monopoly 399

Summary 409

EXAMPLE 13.1

EXAMPLE 14.1

APPLICATION APPLICATION Questions for Review 410 Problems 410 Answers to In-Chapter Exercises 412

13. MONOPOLISTIC COMPETITION 414

Chapter Preview 414

The Chamberlin Model 415

The Spatial Interpretation of Monopolistic Competition 421

Why are there so many fewer grocery stores in most cities now than there were in 1930? Why do residential neighborhoods in New York City have more grocery stores than residential neighborhoods in Los

Angeles? 427

Paying for Variety 428

Consumer Preferences and Advertising 432

Summary 434

APPENDIX: A Simple Model of Spatial Competition 435

Questions for Review 440

Problems 441

Answers to In-Chapter Exercises 442

14. OLIGOPOLY 443

Chapter Preview 444

The Cournot Model 444

Deriving the reaction functions for Cournot duopolists 447

The Bertrand Model 448

The Stackelberg Model 449

Collusion and the Theory of Games 452

The Advertising Arms Race in the Cigarette Industry 455 Strategic Entry Deterrence 462

Contestable Markets 464

Competition When There Are Increasing Returns to Scale 465

The Kinked-Demand-Curve Oligopoly Model 468

Summary 469

Questions for Review 470

Problems 471

Answers to In-Chapter Exercises 472

PART IV FACTOR MARKETS 475

15. LABOR 477

Chapter Preview 478

The Perfectly Competitive Firm's Short-Run Demand for Labor 478 The Perfectly Competitive Firm's Long-Run Demand for Labor 480 The Market Demand Curve for Labor 480 An Imperfect Competitor's Demand for Labor 482 The Supply of Labor 483 The labor supply curve for someone with a target level of income 486 EXAMPLE 15.1 Is Leisure a Giffen Good? 487 The Noneconomist's Reaction to the Labor Supply Model 487 The Market Supply Curve 488 How do rising MBA enrollments affect the salaries and employment of EXAMPLE 15.2 economists in liberal arts colleges? 489 Compensating Wage Differentials: The Case of Safety 490 Monopsony 495 Safety Choices and Relative Income 500 Discrimination in the Labor Market 502 Labor Unions 506 Minimum Wage Laws 508 The Internal Wage Structure 510 The Economics of Superstars 514 Summary 515 Questions for Review 517 Problems 517 Answers to In-Chapter Exercises 519 16. THE ECONOMICS OF INFORMATION (SUPPLEMENTARY) 521 Chapter Preview 521 Communication Between Potential Adversaries 522 The Costly-to-Fake Principle 523 The Full-Disclosure Principle 527 The Lemons Principle: in a certain Eastern bloc country, what frac-EXAMPLE 16.1 tion of personal computers is defective? 531 Choosing a Relationship 532 Adverse Selection 532 Conspicuous Consumption as Ability Signaling 534 Statistical Discrimination 535 The Search for High Wages and Low Prices 540 Search costs and finding the lowest price 543 EXAMPLE 16.2 The Winner's Curse 544 The Winner's Curse: how much should you bid at an auction? 546 EXAMPLE 16.3 Summary 547 Questions for Review 549

Problems 549

Answers to In-Chapter Exercises 551

17. CAPITAL (SUPPLEMENTARY) 552

Chapter Preview 552

Financial Capital and Real Capital 553

The Demand for Real Capital 553

The Relationship Between the Rental Rate and the Interest Rate 554

The Criterion for Buying a Capital Good 555

Interest Rate Determination 556

Real Versus Nominal Interest Rates 557

The Market for Stocks and Bonds 558

Tax Policy and the Capital Market 565

Economic Rent 567

Peak-Load Pricing 568

Natural Resources as Inputs in Production 570

Summary 574

APPENDIX: A More Detailed Look at Exhaustible Resource

Allocation 575

EXAMPLE A.17.1

How would a breakthrough in superconductivity and a subsequent fall in the price of solar energy affect the time path of oil prices, and the point at which we switch from oil to solar power? 579

Questions for Review 580

Problems 580

Answers to In-Chapter Exercises 581

PART V GENERAL EQUILIBRIUM AND WELFARE 583

18. GENERAL EQUILIBRIUM AND MARKET EFFICIENCY 585

Chapter Preview 585

A Simple Exchange Economy 586

Efficiency in Production 595

Efficiency in Product Mix 597

Gains from International Trade 601

EXAMPLE 18.1

As president of a small island nation that has never engaged in free trade, should you retain a closed economy? 602

Taxes in General Equilibrium 603

Other Sources of Inefficiency 605

Summary 607

Questions for Review 608

Problems 608

Answers to In-Chapter Exercises 610

	19. EXTERNALITIES, PROPERTY RIGHTS, AND THE COASE THEOREM 612
	Chapter Preview 612
	The Reciprocal Nature of Externalities 613
EXAMPLE 19.1	The confectioner and the doctor (I): making the confectioner liable for noise damage 614
EXAMPLE 19.2	The confectioner and the doctor (II): changing costs and benefits 615
EXAMPLE 19.3	The confectioner and the doctor (III): installing a soundproofing device 615
EXAMPLE 19.4	The confectioner and the doctor (IV): should the doctor rearrange his office? 616
EXAMPLE 19.5	The confectioner and the doctor (V): negotiating an agreement over noise when both parties can make changes 618
EXAMPLE 19.6	The confectioner and the doctor (VI): negotiating an agreement if only the doctor can make changes 619 Property Rights 620
EXAMPLE 19.7	If village residents make their investment decisions independently, how many of their steers will graze on the commons? 624 Externalities, Efficiency, and Free Speech 626 Smoking Rules, Public and Private 627
EXAMPLE 19.8	Should smoker Smith live with nonsmoker Jones, or find a separate apartment? 628
	Positive Externalities 629
	Positional Externalities 629
	Taxing Externalities 633
EXAMPLE 19.9	The confectioner and the doctor (VII): taxing the confectioner for noise 634
EXAMPLE 19.10	What is the best way for the city council to reduce air pollution? 635 Summary 638
	Questions for Review 639
	Problems 639
	Answers to In-Chapter Exercises 644
	20. GOVERNMENT (SUPPLEMENTARY) 645
	Chapter Preview 646
	Public Goods 646

19. EXTERNALITIES, PROPERTY RIGHTS AND THE COASE

If two people, one rich and one poor, have opposite views on a proposed public project, on what basis would each like to see the decision made, cost-benefit analysis or majority rule? 659

Public Choice 655

Theater? 652

EXAMPLE 20.1

EXAMPLE 20.3 Which company will win the Cedar Rapids cable television franchise? 662

Should the network broadcast Geraldo Rivera or Masterpiece

Income Distribution 662 Summary 673 Questions for Review 675 Problems 675 Answers to In-Chapter Exercises 677

INDEX 679