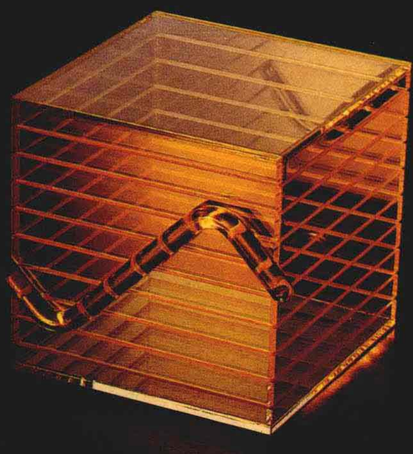
ECONOMICS

Principles and Policy · Third Edition



MICROECONOMICS

William J. Baumol and Alan S. Blinder

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HBJ

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To my three children,
Ellen, Daniel,
and now Sabrina

W. J. B.

For William, who loves to read,
and Scott, who loves to write

A. S. B.

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Preface

For decades, the "principles of economics" book has been expected to codify the entire discipline of economics. In recent years, this has become at once more difficult and more imperative. The explosion of economic knowledge has made it impossible to put all of economics between two covers. But at the same time, more and more public policy issues either are basically economic in nature or involve important economic considerations. Intelligent citizens can no longer afford to be innocent of economics.

While this Third Edition represents an extensive revision of the Second Edition, its preparation continued to be guided by this dilemma. We have studiously avoided the encyclopedic approach and abandoned the fiction, so popular among textbook writers, that literally everything is of the utmost importance. Since students are sufficiently intelligent to see through this ruse in any event, we have tried to highlight those important ideas that are likely to be of lasting significance—principles that you will want to remember long after the course is over because they offer insights that are far from obvious, because they are of practical importance, and because they are widely misunderstood by intelligent laymen. A dozen of the most important of these ideas have been selected as **12 Ideas for Beyond the Final Exam** and are called to your attention when they occur through the use of the book's logo.

All modern economics textbooks abound with "real world" examples, but we have tried to go beyond this, to elevate the examples to preeminence. For in our view, the policy issue or everyday economic problem ought to lead the student naturally to the economic principle, not the other way around. For this reason, many chapters start with a real policy issue or a practical problem that may seem puzzling or paradoxical to noneconomists, and then proceed to describe the economic analysis required to remove the mystery. In doing this, we have tried to utilize technical jargon and diagrams only where there is a clear need, never for their own sake.

Still, economics is a somewhat technical subject and, except for a few rather light chapters, this is a book for the desk, not for the bed. We have, however, made strenuous efforts to simplify the technical level of the discussion as much as we could without sacrificing content. Fortunately, almost every important idea in economics can be explained in plain English, and this, in general, is how we have tried to explain them. Yet, even while reducing the technical difficulty of the book, we have incorporated some elements of economic analysis that have traditionally been left out of introductory books but that are really too important to omit.

One example is our treatment of how the market mechanism is able, under ideal circumstances, to allocate society's resources in the most efficient manner possible. Many introductory texts, thinking the topic too difficult for beginning students, give little more than some general hints about this important result. We offer a genuine proof and an extensive discussion of precisely what the result does—and does not—imply about the efficiency of real-world market economies.

Changes from the Second Edition

Microeconomics

In microeconomics, the discussion continues to be organized around a central theme that we believe deals with the most significant lessons to be learned in an introductory economics course: what a market system does well, and what it does poorly.

Thus Part 1 introduces the central theme and some of the fundamental ideas of economics (such as scarcity, opportunity cost, markets, and prices). Then Part 2 acquaints students with the central analytical tools of microeconomics and uses them to explain how both consumers (Chapters 5 and 6) and producers (Chapters 7 and 8) make decisions that best serve their own interests. Part 3 examines how these decisions interact in the marketplace and provides an extensive examination of the virtues and vices of free markets. The early chapters of Part 3 (Chapters 10 and 11) extol the remarkable accomplishments of an idealized system of markets, while the later chapters (Chapters 12–14) discuss some of the market system's principle failings. In this way, Part 3 sets the stage for Parts 4 and 5, in which we discuss where, why, and how the government intervenes in the economy.

Much of this material has been rewritten and/or reorganized since the Second Edition, partly in response to many extremely useful suggestions we have had from readers. Difficult points are explained more patiently, and there are more examples and graphs than in the Second Edition. In particular, the two chapters summarizing the market's virtues (Chapter 11) and vices (Chapter 14) now come much closer together in the text, and much of the "core" microeconomic chapters (Chapters 3 and 4 and 5–8) has been completely rewritten.

Revisions were particularly extensive in Chapters 6 (Consumer Demand and Elasticity) and 7 (Inputs and Costs). Chapter 6 now has a much more detailed, step-by-step description and explanation of the important elasticity concept, featuring many more examples. To improve its exposition, Chapter 7 has been divided into two parts.

The first part deals with the analytically simpler case in which the quantity of only one input is chosen. Using this simplification, we discuss how input choice determines the firm's cost curves—which are so crucial for the analysis of the output decisions of the enterprise described in the following chapter. We also introduce and explain the distinction between fixed and variable cost and that between the short and long run. These concepts, which have been moved here from the following chapter, are used to explain the characteristic shapes of the firm's cost curves.

The new second part of Chapter 7 deals with the complications that arise when many inputs are chosen at once. The cost-minimizing combination of inputs is analyzed, and phenomena such as the "law" of diminishing returns and returns to scale are examined and contrasted. The material is written so that the instructor can, without loss of continuity, postpone the multi-input discussion until later in the course, or can omit it entirely.

The policy-oriented chapters have been updated to reflect new developments in regulatory (Chapter 15), antitrust (Chapter 16), and environmental (Chapter 18) policy, heightened interest in tax loopholes and flat-rate taxes (Chapter 17), and the diminished importance of the "energy crisis" (Chapter 19). The new theory of "contestable markets" is introduced in Chapter 13 and referred to in several other chapters.

The chapter on international economics, 23 (and Chapter 19 in *Macroeconomics*), has also been revised extensively. Chapter 23 has a different, more patient, and more detailed explanation of comparative advantage, and much more material on current issues in trade policy.

Some twenty years of lag in the growth rate of American productivity behind that of a substantial number of European and Far Eastern countries has elicited worries about the consequences for U.S. competitiveness. Our belief that U.S. productivity performance will continue to be a major concern of policymakers has prompted us to add an entirely new chapter on this subject. Our new Chapter 24 describes the pertinent facts, examines some of the explanations that have been offered, analyzes the consequences of a protracted lag in productivity growth, and discusses some of the productivity stimulation policies that have been proposed.

Studying Principles of Economics

Whatever the nature of your course, we would like to offer one suggestion. Unlike some of the other courses you may be taking, principles of economics is cumulative—each week's lesson builds on what you have learned before. You will save yourself a lot of frustration (and also a lot of work) if you keep up on a week-to-week basis. To help you do this, there is a chapter summary, a list of important terms and concepts, and a selection of discussion questions to help you review at the end of each chapter. In addition to these aids, many students will find the *Study Guide,* designed specifically to accompany this text by Professor Craig Swan, helpful as a self-testing and diagnostic device. When you encounter difficulties in the *Study Guide,* you will know which sections of the text you need to review.

Note to the Instructor

In trying to improve the book from one edition to the next, we rely heavily on our own experiences as teachers. But our experience using the book is miniscule compared to that of the hundreds of instructors who use it nationwide. If you encounter problems, or have suggestions for improving the book, we urge you to let us know by writing to either one of us in care of Harcourt Brace Jovanovich, College Department, 1250 Sixth Avenue, San Diego, California 92101. Such letters are invaluable, and we are glad to receive them, even if they are critical.

What follows is a set of suggested course outlines.

OUTLINE FOR A ONE-SEMESTER COURSE IN MICROECONOMICS

Chapter Number	Title
1	What Is Economics?
2	The Use and Misuse of Graphs
3	*The* Economic Problem
4	Supply and Demand: An Initial Look
5	The Common Sense of Consumer Choice
6	Consumer Demand and Elasticity
7	The Common Sense of Business Decisions: Inputs and Costs
8	The Common Sense of Business Decisions: Outputs and Prices
9	Firms in Reality: The Corporation and the Stock Market
10	The Firm in the Marketplace: Perfect Competition
11	The Price System and the Case for Laissez Faire
12	Pure Monopoly and the Market Mechanism
13	Between Competition and Monopoly
14	Shortcomings of the Market Mechanism and Government Attempts to Remedy Them
15	Limiting Market Power: Regulation of Industry
16	Limiting Market Power: Antitrust Policy
17	Taxation, Government Spending, and Resource Allocation
20	Input Prices: Interest, Rent, and Profits
21	The Labor Market and Wages

Plus Any Two of the Following:

18	The Economics of Environmental Protection
19	The Economics of Energy and Natural Resources
22	Poverty, Inequality, and Discrimination
25	Marxian Economics
26	Comparative Economic Systems: What Are the Choices?
27	Dissenting Opinions: Conservative, Moderate, and Radical

OUTLINE FOR A ONE-QUARTER COURSE IN MICROECONOMICS

Chapter Number	Title
3	*The* Economic Problem
4	Supply and Demand: An Initial Look
5	The Common Sense of Consumer Choice
6	Consumer Demand and Elasticity
7	The Common Sense of Business Decisions: Inputs and Costs
8	The Common Sense of Business Decisions: Outputs and Prices
9	Firms in Reality: The Corporation and the Stock Market
10	The Firm in the Marketplace: Perfect Competition
11	The Price System and the Case for Laissez Faire
12	Pure Monopoly and the Market Mechanism
13	Between Competition and Monopoly
14	Shortcomings of the Market Mechanism and Government Attempts to Remedy Them
17	Taxation, Government Spending, and Resource Allocation
20	Input Prices: Interest, Rent, and Profits
21	The Labor Market and Wages

With Thanks

Finally, and with great pleasure, we turn to the customary acknowledgments of indebtedness. Ours have been accumulating now through three editions. In these days of specialization, not even a pair of authors can master every subject that an introductory text must cover. Our friends and colleagues Charles Berry, William Branson, Lester Chandler, Gregory Chow, Avinash Dixit, Stephen Goldfeld, Claudia Goldin, Ronald Grieson, Daniel Hamermesh, Peter Kenen, Melvin Krauss, Arthur Lewis, Burton Malkiel, Edwin Mills, Janusz Ordover, Uwe Reinhardt, Harvey Rosen, Hans Soderstrom, Laura Tyson, and Martin Weitzman have all given generously of their knowledge in particular areas over the course of three editions. We have learned much from them, and only wish we had learned more.

Many economists at other colleges and universities offered useful suggestions for improvements, many of which we have incorporated into the Third Edition. We wish to thank Mohsen Bahmani-Oskooee of University of Wisconsin–Milwaukee, Philip Bartholomew of University of Michigan, Merton Bernstein of Washington University, Vito Blomo of East Carolina University, Martin Bronfenbrenner of Aoyama Gakuin University (Tokyo), Robert Cherry of Brooklyn College, Fred Curtis of Drew University, Lawrence De Brock of University of Illinois–Champaign, Susan Feiner of Virginia Commonwealth University, Donald Frearson of Western Australian Institute of Technology, Gordon Galbraith of Portland Community College, R. Scott Gassler of Guilford College, Dermot Gately of New York University, David George of LaSalle College, Amyra Grossbard-Shechtman of San Diego State University, Art Gutowsky of California State University–Sacramento, James S. Hanson of Willamette University, Derek Jones of Hamilton College, Abraham Kidane of California State University–Dominguez Hills, Gary F. Langer of Roosevelt University, Alan Mandelstamm of Virginia Polytechnic Institute and State University, Benjamin N. Matta of New Mexico State University, Henry N. McCarl of University of Alabama–Birmingham, William Mounts of Mercer University, Mark Plant of University of California–Los Angeles, Robert Reilly of Virginia Commonwealth University, David Ring of State University of New York–Oneonta, Richard Roehl of University of Michigan–Dearborn, Francis (Bill) Rushing of Georgia State University, William Sher of Duquesne University, Mary A. Shulman of Northwestern University, James Starkey of University of Rhode Island, Robert Thomas of Iowa State University, William Thweatt of Vanderbilt University, Samuel Torres-Roman of University of Puerto Rico, Kay Unger of University of Montana, Bernard Wasow of New York University, James

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We were, of course, most gratified by a number of spontaneous and kind letters from student readers. Since it is for such readers that the book is primarily intended, no other comments have meant as much to us.

The book you hold in your hand was not done by us alone. The fine people at Harcourt Brace Jovanovich, including Hannah McHugh, Johanna Schmid, Barbara Girard, Avery Hallowell, Don Fujimoto, and Fran Wager, worked hard and well to turn our manuscript into the book you see. We appreciate their efforts.

Our sanity and survival during the preparation of the Third Edition were assured by the intelligence, ability, and pleasantness of our secretaries, Phyllis Durepos and Mary Mateja, who did so many things and did them all so well. Sue Anne Batey Blackman, who seems to know our thoughts on the subject better than we do ourselves, brought up to date the chapters on the environment and the economics of natural resources.

And finally there are our wives, Hilda Baumol and Madeline Blinder. They have now participated in this project for nine years, and with each successive revision they help in more and more ways. Their patience, good judgment, and love have made everything go more smoothly than we had any right to expect. We salute them.

William J. Baumol
Alan S. Blinder

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