



# CONTEMPORARY ECONOMICS

JAMES R. KEARL

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## To the Instructor

*Contemporary Economics* is intended to be a serious introduction to economics suitable for a one-semester course comparable in quality and rigor to the traditional two-semester courses offered at many schools. In this sense, the text is closer to the common two-semester encyclopedic text than it is to most of the one-semester texts on the market. *Contemporary Economics* is necessarily more focused than the larger two-semester texts, many of which present economics in a smorgasbord fashion. A small number of themes are developed in a consistent, sequential manner. There is a logical development that gives order to the topics treated and ties the topics together in such a way that later chapters build on earlier chapters in terms of analysis and sophistication. Most of the more specialized topics covered in individual chapters in other texts have not been ignored, but are treated as applications of the specific, broader ideas developed.

*Contemporary Economics* does not focus on a particular subset of the collection of topics of a larger text, nor does it adopt a single perspective on economics. It tries to teach first and foremost how markets work, and, secondarily, how governmental activities must necessarily affect markets. Individual and market behavior are viewed, in a sense, as constraints on governments that determine, along with whatever policy is pursued, the actual outcome that the policy achieves. At the same time, *Contemporary Economics* suggests that markets do not always work well. Attention is paid to the critical assumptions that ought to be examined in the public-policy debate about the intertwined roles of markets and governmental policy.

*Contemporary Economics* has two different aims. For students who will not continue in economics, the text tries to provide a sensible introduction to the way that a market economy works and how a market economy and governmental

policies interact. The institutional arrangements and workings of the economy discussed are those that are generic to "market economies."

For students who will continue in economics, the text tries to stimulate thought—first, about what are the questions, problems, and issues of interest and importance in economics, and second, about the different ways that one might approach these questions, problems, and issues.

*Contemporary Economics* begins with an introduction that poses the central policy issue: How should a society balance its reliance on decentralized markets against centralized governmental activities in responding to the problems posed by scarcity (how to effectively use scarce resources and best coordinate competing interests)? The text is then divided into five parts. Each part begins with a short introduction that lists the key ideas and themes that will be developed in the chapters that follow. The hope is that a student will be able to step back occasionally and see the broader issues and themes amid the particulars of each chapter. I have made extensive use of boxed examples to extend the material in the text. Many of these are empirical in nature, providing "real world" perspectives on the somewhat more abstract material in the body of the text. Each chapter ends with a list of review questions designed to stimulate thought and serve as the basis for formal and informal discussion. Answers to selected questions are provided at the end of the text along with an extensive glossary.

For the most part, the development in Parts II (microeconomics and market efficiency), III (microeconomics and market failure), and IV (macroeconomics) is quite traditional. Part I (exchange, specialization, institutional arrangements, and "tools") is somewhat "nontraditional." It is my view, however, that the common starting place for economics textbooks (supply and demand followed by microeconomics or macroeconomics) does not provide an appro-

appropriate foundation for understanding *why* markets may be important. Therefore, this text starts with exchange and specialization. In addition, the usual approach does not confront the coordination problem which is at the heart of any debate over the appropriate balance between markets (decentralized coordination) and government (centralized coordination) in an economy.

Part I also mixes traditional micro and macro topics in a “nontraditional” way. It is easy, convenient, and important to develop the role of money in reducing the transaction costs that accompany exchange and specialization. It is then useful to examine other devices that also lower transaction costs, including firms and property rights. However, once the idea of money has been developed, it is also useful to discuss measurement issues. The early development of money makes an easy transition into measurement issues and the use of money measures of prices and other things throughout the remainder of the text. As a consequence, it is easier to make the distinction between real and nominal variables and to use various aggregate measures in the micro chapters when appropriate. Introducing these measures at this point also has the advantage of tying what the student hears most frequently on the news to the text at an early point. Finally, it provides a clear distinction between relative prices and the price level, and between changes in relative prices and changes in the price level.

The text attempts to balance micro issues and macro issues, but it does so by weaving them together to some degree. Thus, while Parts II and III can be thought of as “microeconomics” and Part IV as “macroeconomics,” the role of money is introduced in chapter 4. Price indices and aggregate output measures are introduced in chapter 6. Labor and capital markets (including investment) are discussed at some length in chapter 13. Chapters 20 through 25 (Part IV) then build on these beginnings. The text does not treat macroeconomics as something apart from the rest of economics. Traditional macro issues are treated as a natural extension of the underlying themes in the text: How do market economies work, and how do government policies affect how markets work?

In our modern world, international issues are of increasing importance. Rather than treat them completely separately, I have woven many

of the traditional topics in this area through the text. For example, the discussion of exchange and specialization in chapter 2 first focuses on individuals, then on economies. The micro effects of trade are dealt with in chapter 12. In addition, chapter 12 uses currency markets as an extended example of supply-demand analysis. Chapter 14 deals, in part, with distortions of international trade. Finally, chapter 24 considers some of the macroeconomic consequences of the movement of commodities and assets between economies. Many of the boxed examples throughout the text also focus on international issues.

A teacher’s manual is available which includes model syllabi, answers to end-of-chapter questions, some supplementary materials for selected chapters, and a test bank.

A study guide, by John Leadley of Illinois State University, provides a concept review of each chapter, including key graphs and equations. The study guide also includes short applications, multiple choice questions, and problems, all with full solutions.

Many individuals have contributed to this text, which has had an extraordinarily long gestation period. I wish to thank in particular Brigitte Condie Madrian, my research assistant, and George Lobell, Bruce Kaplan, and Mark Grimes, my editors at Scott, Foresman and Company. The following individuals reviewed various parts of the text and provided valuable comments and criticisms:

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## ***To the Student: An Overview***

*Contemporary Economics* tries to tell a connected, consistent, compelling, and even stimulating tale. The plot is simple:

Resources are scarce. Because of scarcity, two problems arise. First, individuals and societies must make choices and these choices will be costly. Second, individual and group activities will compete with other individual and group activities which, as a consequence, will require some kind of social coordination.

Scarcity also stimulated important economic activities, particularly the *exchange* of goods, services, and resources between individuals and between economies, and the *specialized production* activities in which most of us participate. Exchange and specialization, in turn, stimulate the development of social arrangements, including money, firms, intermediaries, contract rules, and property rights, to fully exploit the gains associated with these two economic activities.

Every society has to decide how it will confront the problems that are a consequence of scarcity and determine what organization will best take advantage of the gains from exchange and specialization. It turns out that free markets are useful devices in forcing individuals to consider the costs of their decisions, organizing economic activities, coordinating competing individual and group activities, and taking advantage of gains associated with exchange and specialization. These “market successes” contribute in very important ways to your well-being and make an economy based on free markets attractive.

For a variety of reasons, however, governments choose to distort the market outcomes which would otherwise occur. In addition, free markets may encounter allocational difficulties. That is, markets may not always organize activities in such a way that the costs associated with scarcity are apparent. Nor do markets always coordinate competing activities in effective ways. Thus, markets may lead to monopolies, pollu-

tion, poor information, few social services, an unfair distribution of income, unemployment, inflation, or economic stagnation. These difficulties are “market failures” that need to be remedied because they undermine personal well-being. Importantly however, for each market failure there exists, at least in principle, an effective public-policy remedy. But alas, governmental efforts to solve these problems are not free from difficulties themselves and often produce unintended and adverse outcomes.

We are left, then, with the extraordinarily important public-policy issue: How should a society balance its reliance on “less-than-perfect” markets to organize economic activity against the “less-than-fully-effective” governmental remedies whose intended effect is to offset the imperfect market outcomes?

While *Contemporary Economics* pursues the simple plot just outlined, it has two other important themes as well: First, how do markets work? Second, how do governmental activities and policies affect how markets work?

Part I begins by tracing the consequences that follow when individuals have to deal with scarcity, or in words more familiar to an economist, when individuals confront constraints. We will find that scarcity forces individuals to make choices and that choices have costs. We will also find that social coordination problems emerge when groups of individuals confront constraints because scarcity also leads to competition.

We then focus on the foundation of economic activity: the enormous benefits that come when individuals (and economies) can exchange, and because they can exchange, specialize in productive activities. Exchange and specialization are carefully and extensively explored. It turns out that exchange and specialization are ways of dealing with the problems of costs and competition posed by scarcity. In addition, and of particular importance, the gains from exchange and



specialization stimulate the development of institutional arrangements that allow groups of individuals to capture the enormous benefits associated with these two economic activities.

Some institutional arrangements have properties such that when individuals pursue only their own interests, the well-being of others is enhanced; some do not. This poses a serious problem for society since we must choose the kind of institutional arrangements to adopt in order to facilitate economic activity. This problem has several dimensions that can be illustrated by a series of questions: How can self-interested motives be accommodated to take advantage of the benefits associated with exchange and specialization? How can a stable social order emerge when individuals pursue their own interests and have little interest in the social order *per se*? How does a decentralized economy choose to produce some goods and not others? Is it able to respond to the interests of those who live within it? Are some allocations of resources, goods, and services better than other allocations? Why? How does the distribution of goods and services change when the allocation of resources changes? Why does economic activity appear to ebb and flow, with unemployment at times and inflation at other times? Why do some economies grow while others stagnate?

Although exchange and specialization provide the possibility for enormous gains in individual well-being, they are also costly. It turns out that the gains from exchange and specialization are such that new institutional arrangements may arise in any economy in order to minimize some of these costs. These arrangements include things with which you are quite familiar, like money, and some with which you may be less familiar (at least as arrangements whose purpose is to lower transaction costs), like financial institutions, business firms, brokers, property rights, and contracts.

The problems of accommodating exchange and specialization are particularly interesting when individuals are self-interested and when scarcity imposes constraints and creates costs. Since the pursuit of self-interest appears to play an important role in our lives, the meaning of self-interest is also explored in Part I, including an analysis of rational choice and marginal decision making.

Part I ends on a slightly different note, but one that is very important for the progress of

economics as a social science or discipline—the ability to measure economic activity. With money, an economy has a useful measuring device (a unit of account), and as a consequence some kinds of economic activities can be measured and monitored. This allows us to mark our economic progress; it also allows us to conveniently summarize economic data in ways that are easy to communicate and understand. Thus in the concluding chapter in Part I, we consider some common measures of prices and output that are available because money can be used as a way of accounting for economic activity.

Part II focuses on markets. This section is the “nuts and bolts” of the text: How do markets work? How are prices, profits, and production decisions determined? What role do prices and profits play? How do markets organize exchange, stimulate specialization, and accommodate competing interests? What is a market equilibrium? How do markets adjust? How responsive are prices and production decisions to changes in the economic environment?

The section begins with an introduction to the general ideas of relative prices, demand, supply, equilibrium, adjustment, and elasticity. We then explore more carefully the idea of demand. This is followed by an analysis of short-run supply, short-run market adjustment, and short-run market equilibrium. This “short-run analysis” is, in turn, followed by an analysis of long-run supply, long-run market adjustment, and long-run market equilibrium. The respective roles of relative prices, profits, and rents in market adjustments are emphasized. We then explore the idea of efficiency, or put differently, the sense in which markets contribute to your well-being.

Since markets within an economy are linked to markets in other economies by international trade, we next consider the effects of the international flow of goods, services, and resources on the domestic use of resources and on domestic market prices, adjustment, and market equilibrium. We then consider the markets for two important resources—labor and capital. The analysis of these markets, while of considerable interest in its own right, is also important in understanding the coordination problems discussed at length in Part IV.

This section ends with an extended discussion of the ways in which competitive markets are distorted or changed by government policies.

These market distortions include price ceilings, price floors, taxes, subsidies, prohibitions on market activities, restrictions on entry or exit, and barriers to international trade. The effects of each of these distortions on relative prices, profits, rents, market adjustment, equilibrium, and efficiency are considered.

Having outlined the “successes” of competitive markets and the “distortions” of market outcomes by public policies, we next consider (in Parts III and IV) the various ways in which markets “fail” and some of the possible policy responses to these “market failures.” Separate chapters are devoted to monopoly, externality, and public good problems. The general idea of a monopoly is probably familiar to you, externalities and public goods may be less so. The former includes problems such as pollution and environmental degradation; the latter includes problems such as parks, roads, and national defense. Monopolies, externalities, and public goods are problems in the sense that if a market is monopolized, or has externality difficulties, or if markets try to allocate public goods, inefficient uses of scarce resources will result. Imperfect information and uncertainty may also create problems in a market economy. The nature of these problems is also explored in Part III.

The concluding chapter in Part III addresses the issues of economic justice and a fair distribution of goods and services. The purpose of this effort is to engage you in a dialogue about the meaning of “fair” in a market context and to provide evidence about the way that the U.S. economy distributes rewards among the participants in the economy.

Part IV considers three particularly important aspects of market failure: unemployment, output cycles, and inflation. Instead of focusing on particular markets, we will examine the behavior of the economy as a whole. In a large, complex economy, lack of coordination among certain markets may lead to periods in which resources are unemployed or in which most prices are increasing or decreasing. We would like to understand why this is so.

In this section, we focus on the price level, real and nominal aggregate output, employment, unemployment, aggregate demand, and aggregate supply. A simple model of aggregate supply (the total value of all goods and services produced by an economy) is developed that depends

upon how individuals and firms respond to information about the economy, particularly as they make labor supply and labor demand decisions. It turns out that economies appear to adjust differently in the *short run* than they do in the *long run*. Hence, we distinguish between the two. The intent of this effort is to try to understand why economies have unemployed resources, inflation, and fluctuating output. In addition, however, supply-side economic policies, which have been of considerable interest in the past several years, are introduced in a simple setting in which tax policy affects the labor market and, hence, long-run aggregate supply.

You should be forewarned that there are a number of unresolved puzzles in this area. For example, it is not clear why some markets do not quickly reach an equilibrium, particularly the labor market. One possibility is that there are informational difficulties that create adjustment problems. If these informational difficulties cause problems in labor markets, an economy may, for a time, have unemployed resources. However, such problems are not likely to persist for extended periods of time and, hence, an economy with unemployed resources will likely move toward full employment in the long run. Since there are many unanswered questions in this important area, the discussion in these chapters focuses on what we know and what we do not know about the aggregate outcome for an economy that relies on markets.

The development of aggregate demand introduces a traditional distinction that economists make between consumption, investment, and government uses of real output. The problem of coordinating decisions to consume and save with investment decisions is explored. It is possible that as an economy adjusts, these coordination problems affect the level of aggregate demand. If they do, the resulting changes in aggregate demand may then force adjustments in labor markets. Unless labor markets adjust quickly to such changes, the results will be particularly costly for the economy: individuals may be unemployed. Hence, movements in aggregate demand are thought to be an important source of fluctuations or cycles in real output, the price level, and employment opportunities.

There are two kinds of economic policies that may be able to offset real output, price level, or employment changes: fiscal policy and mon-



etary policy. Fiscal policy directly affects aggregate demand through the government's use of real resources. The government can increase its use of such resources and stimulate the economy or it can decrease its use of such resources and dampen economic activity. The government can also indirectly influence private uses of real resources, including private consumption, saving, and investment decisions, by changing the taxes that individuals or firms must pay. Government expenditure and tax changes that are specifically directed at offsetting aggregate demand changes or at stimulating aggregate supply are collectively referred to as fiscal policies.

Monetary policy is the use of the government's control of the money supply to offset aggregate demand changes, but is somewhat less direct in its effects than fiscal policy. Money is used as a device to lower transaction costs. Money is also used as an instrument for holding wealth. But while money is almost unique in its use in transactions, it is only one of many assets which an individual might use to hold wealth. The kinds of assets individuals choose to hold depends, in part, on the earnings or interest payments associated with the various assets. One way that monetary policy affects the economy is through its effect on these interest rates.

In order to understand the relationship between monetary policy and aggregate demand, we begin (chapter 23) by examining the role of banks and the Federal Reserve System in the creation of money. There are a number of ways that the Federal Reserve can affect the quantity of money in the U.S. economy, including open-market operations (where the Federal Reserve buys and sells bonds), changing the discount rate (the interest rate the Federal Reserve charges for loans to banks), and changing the reserve requirement (the amount of reserves that banks must keep on deposit against accounts that they issue to individuals). Monetary policy is explored in terms of the effect of these policy tools on interest rates and hence on aggregate demand.

The analysis in this part of the text concludes with a discussion of the government budget constraint, government budget deficits and their pos-

sible effects on private investment, and the effects of the movement of commodities and assets between economies. Since this is an area of substantial change and some turmoil, we will explore those areas where different views about the critical parameters that determine the effectiveness of public policies, individual behavior, or the "essential" interactions in the economy would make a difference in the policy perspective that might be adopted.

Part V concludes the text by pointing to the problems of making public economic policy when individuals, in self-interested ways, attempt to use governmental policy processes to increase their own wealth. In particular, we will examine the efforts of individuals to use the power of the government to create economic benefits for some people, as well as the economic effects of competition among individuals for these benefits. These efforts sometimes create policies that are not consistent with the market problems they were intended to solve. How we balance the problems associated with markets with the problems associated with government intervention is *the* important question in public policy. It is a question without a firm answer for all times and all places—the balance changes from time to time and between generations. What you discover as you think carefully about economics will prepare you to be an effective participant in the debate about how we ought to balance these choices.

Learning about technical details, while often not much fun, is important in being able to respond intelligently and critically to the claims about the economy that you will frequently encounter. Such details necessarily get you focused on small issues rather than on the larger picture or theme. However, since it is often easy to become so caught up in details that we "miss the forest for the trees," I encourage you to return frequently to this overview and to that provided at the beginning of each part of the text so that you can keep a clear sense of the direction in which the text is leading you.

J. R. Kearn

# Contents

## *To the Student: An Overview* xxii

## **PART ONE** *Exchange, Specialization, and Transaction Costs* 2

### **CHAPTER ONE** *Scarcity, Choices, and Costs* 4

---

Scarcity and Constraints	4	The Social Coordination Problem	13
Choices	5	Self-Interested Individual Behavior	
Choices about Leisure and Work		Methods of Social Coordination	
Choices about What to Produce and Consume		The Effects of Self-Interested Interactions	15
Choices about Present versus Future Consumption		Everyone Is Worse Off	
Costs	6	Some Are Better-Off (But Only Because Others Are Worse Off)	
Opportunity Costs		Everyone Is Better-Off	
Constraints and Opportunity Costs		Individual Outcomes and Social Aggregation	19
A Production-Possibilities Frontier		The Inference Problem	21
The Effect of Different Leisure-Work Choices		Individual Behavior versus Social Structure	
The Effect of Skill and Resource Availability		The Perspective of an Economist	
An Aside: Logical Models	11	The Public-Policy Problem	
Scarcity, Competition, and Conflict	12	Summary	22
		Discussion and Thought Questions	23
EXAMPLE 1.1	The Changing Cost of Your Education	7	
EXAMPLE 1.2	Choosing a Job	10	
EXAMPLE 1.3	Invoice Prices and Opportunity Costs	14	
EXAMPLE 1.4	The Opportunity Costs of Watching TV	16	
EXAMPLE 1.5	Does It Cost to Limit Speeds to 55 MPH?	19	

### **CHAPTER TWO** *Exchange and Specialization* 24

---

Exchange and the Invisible Hand	24	Friday's Ability to Produce and Consume	
More Is Preferred to Less		Specialization	
Different Individual Preferences		Specialization and Productivity	
A Fortuitous Interaction		Relative Costs	
Exchange		Deciding on Specialization	
Learning from the Simple Exchange Model		Relative Prices	32
Specialization and the Invisible Hand	27	Four Important Points	32
Crusoe's Ability to Produce and Consume		Opportunity Costs and Specialization	

Comparative versus Absolute Advantage	
Distributing the Gains	
Maximizing Output	
International Trade	36

EXAMPLE 2.1	Life in a Suq	32
-------------	---------------	----

Interdependence	37
Summary	37
Discussion and Thought Questions	37

### **CHAPTER THREE Social Choices 39**

---

Aggregate Production Possibilities	39
An Aggregate Production-Possibilities Frontier	
Increasing Social Costs	40
Aggregate Consumption Possibilities	
Choosing Between Arms and Food	
Efficient Use of Resources	43
Relative Prices and Production	43
Relative Prices and Decentralized Choices	
The Aggregate Effects of a Change in a Relative Price	

Distribution of Income Within an Economy	44
Relative Price Changes and Distribution Effects of International Trade	
Making Social Choices	47
Economic Growth	48
Production of Capital	
Dramatic Changes in Resources and Production Possibilities	
Summary	51
Discussion and Thought Questions	52

EXAMPLE 3.1	Oil Price Changes	45
-------------	-------------------	----

EXAMPLE 3.2	Can a High-Wage Economy Compete with Low-Wage Economies?	46
-------------	--	----

EXAMPLE 3.3	Trade and Jobs	47
-------------	----------------	----

EXAMPLE 3.4	The Social Costs of a Volunteer Army	50
-------------	--------------------------------------	----

### **CHAPTER FOUR Costly Transactions, Money, and the Rules of the Game 53**

---

Money	54
Problems with Barter	
Using Money Instead of Bartering	
Acceptability	
Uniformity	
Divisibility	
Stability of Value	
Historical Development	
Intrinsic Worth versus Legal Tender	
Intermediaries	58
Direct versus Indirect Exchange	
Intermediaries and Productivity	
Firms	60
Team Production	
The Monitoring Problem	
Hierarchical Organizations	
Opportunistic Behavior	
Households	63

Further Specialization	
Developing Labor Resources	
Rules of the Game	65
Property Rights	
Expectations	
Incentives	
Ownership	
Restrictions on Property Rights	
Transaction Costs and Property Rights	
Contracts	
Summary	70
Discussion and Thought Questions	70

EXAMPLE 4.1	Vasectomies and Leaky Radiators	55
-------------	---------------------------------	----

EXAMPLE 4.2	Is Barter Really This Bad?	56
-------------	----------------------------	----

EXAMPLE 4.3	Life in a Suq, Once Again	62
EXAMPLE 4.4	The Importance of Reputation in the Diamond Market	67

## **CHAPTER FIVE Economic Choice and Marginal Analysis 72**

---

Making Choices	72	Choosing the Best Option
Deciding Who Should Choose		The Margin Matters, Not the Average
Traditional Choices		Sunk Costs Are Irrelevant
Random Choices		The Equi-Marginal Principle
Purposeful Choices		The Importance of Marginal Analysis
Rational Choices and Information	73	Marginal Decision-making
Comparability		Description versus Prescription
Consistency		Summary
Information		Discussion and Thought Questions
Problems Due to Lack of Information		
Motive versus Constraints		
Maximization and Marginal Analysis	76	
Diminishing Marginal Returns		
Marginal Benefits		
Marginal Costs		
EXAMPLE 5.1	Preferences for Children	74
EXAMPLE 5.2	Diminishing Returns in Emissions Control	76
EXAMPLE 5.3	Diminishing Returns in Cotton-Dust Control	77
EXAMPLE 5.4	The Diamond-Water Paradox	81
EXAMPLE 5.5	Are Criminals Rational?	84
EXAMPLE 5.6	Sunk Costs and Electrical Utilities	85
EXAMPLE 5.7	Sunk Costs and Mistakes	87

## **CHAPTER SIX Measuring Economic Activity 89**

---

Money as a Unit of Account	89	Measuring Output	96
Relative Prices and Money Measures of		Price Changes and GNP	
Prices	89	Non-Market Activities and GNP	
The Effects of Inflation and Deflation		Underground Economy and GNP	
The Price Level and Price Indices	90	Financial and Second-Hand Transactions	
A Price Index for a Single Good		and GNP	
Measuring Inflation and Deflation		Population Change and GNP	
The Period of Measurement		Individual Well-Being and GNP	
A Price Index for Many Goods		National Income Accounts	101
Common Price Indices		Summary	102
The Purchasing Power of Money		Discussion and Thought Questions	103
Problems with Price Indices			
A Useful Approximation			
EXAMPLE 6.1	Where the Domestic Money Is Not the Unit of Account	90	
EXAMPLE 6.2	Price Level versus Relative Price Changes	92	
EXAMPLE 6.3	Different Consumption Patterns	94	
EXAMPLE 6.4	Changes in the Consumption Pattern Over Time	95	
EXAMPLE 6.5	The CPI's New Basket	98	

## **PART TWO   Markets for Goods, Services, and Resources: Prices, Profits, Adjustment, and Equilibrium   104**

### **CHAPTER SEVEN   Markets   106**

---

Suppliers and Demanders   107	A Shift in Supply
Market Supply	Other Possible Adjustments
Measuring Relative Prices	An Aside: A Change in Demand or Supply
Measuring Quantities	versus A Change in Quantity Demanded or
Supply Curves	Quantity Supplied   116
Market Demand	Elasticity   117
Creating Markets	Price Elasticity of Demand
Adjustment   110	Measuring the Elasticity of Demand
Excess Supply	Calculating Elasticities
Excess Demand	The Importance of the Elasticity of
Eliminating Excess Supply	Demand
Eliminating Excess Demand	Price Elasticity of Supply
Predictability	The Importance of the Elasticity of Supply
Equilibrium   113	Summary   124
Adjustment and Equilibrium   114	Discussion and Thought Questions   124
A Shift in Demand	
EXAMPLE   7.1    What Happens When Demand Shifts, I?   111	
EXAMPLE   7.2    What Happens When Demand Shifts, II?   113	
EXAMPLE   7.3    What Happens When Supply Shifts?   118	
EXAMPLE   7.4    A Supply Shift   121	
EXAMPLE   7.5    Elasticity of Demand and a Supply Shift   123	

### **CHAPTER EIGHT   Demand   126**

---

Explaining Behavior: The Economic	Willingness-to-Pay versus Ability-to-Pay
Approach   126	Changes in Demand When Other Prices
The First Law of Demand and Behavior	Change   138
Subtleties of Behavior and Demand	Complements
Demand   128	Substitutes
Individual Choices When Relative Prices	Changes in Demand When Individual Income
Change	Changes   141
Substitution	Normal Commodities
Substitution and Maximization	Inferior Commodities
Diminishing Marginal Satisfaction	Other Things That Affect Demand   142
Willingness-to-Pay	Transaction Costs
Market Demand   133	Transportation Costs
The First Law of Demand	Taxes
Evidence	Determining the Price
Consumers and Market Demand	Population Changes
Learning About Individual Consumers from	Changes in Tastes and Preferences
the Market Demand	The First Law of Demand, Once Again   145
The Market Price	The Second Law of Demand   148
Willingness-to-Pay and Market Demand	Estimating the Size of the Elasticity of
Economizing	Demand



Elasticity of Demand and the Relative Importance of Commodities in Individual Budgets	Income Elasticity of Demand
Substitution Over the Short and Long Term	Cross Price Elasticity of Demand
An Aside: Other Elasticities 150	Exceptions to the Law of Demand 152
	Summary 153
	Discussion and Thought Questions 153
EXAMPLE 8.1 Who Believes Demand Curves Slope Downward? 127	
EXAMPLE 8.2 The Demand for Vanity 129	
EXAMPLE 8.3 The Demand for Charitable Giving 131	
EXAMPLE 8.4 Is a Brown Paper Bag as Good as Cellophane? 132	
EXAMPLE 8.5 Is Gasoline in the Suburbs a Substitute for Gasoline in the City? 135	
EXAMPLE 8.6 The Demand for Shakespeare 137	
EXAMPLE 8.7 Public Policy and Income and Substitution Effects 144	
EXAMPLE 8.8 The Income Elasticity for Wives 145	
EXAMPLE 8.9 The Demand for Dental Care 146	
EXAMPLE 8.10 Price, Income, and Cross Price Elasticities 147	

## **CHAPTER NINE Short-Run Competitive Supply 155**

---

Firms 155	Short-Run Marginal Costs 163
Integration and Organization	Profit Maximization and a Firm's Competitive Supply 165
Ownership and Profits	To Produce or Not to Produce 166
Time Horizons and a Firm's Stock of Capital	Market Supply 167
Profits 157	Learning about Individual Firms from the Market Supply
Revenues	Adjustment and Equilibrium Revisited 168
Costs	An Increase in Demand
Profit Maximization 158	A Decrease in Demand
Competitive Markets 160	A Decrease in Supply
Competitive Markets and a Firm's Demand Schedule	Incentives to Adjust
When a Firm's Output Has a Greater Elasticity than the Market Demand	Summary 171
Marginal Revenues for a Firm in a Competitive Market 162	Discussion and Thought Questions 171
EXAMPLE 9.1 Elasticity of Supply in Agricultural Markets 164	

## **CHAPTER TEN Long-Run Competitive Supply 173**

---

Profits and Incentives to Exit or Enter 173	Average Costs, Marginal Costs, and Profits, More Generally
Long-Run Market Equilibrium 174	The Relationship Between Averages and Marginals
Long-Run Consequences of Short-Run Economic Profits	Entry and Long-Run Supply 182
Long-Run Consequences of Short-Run Economic Losses	New Entrants and Existing Firms
Long-Run Consequences of Zero Economic Profits	Long-Run Adjustment 186
Average Costs 176	Constant Long-Run Average Costs
Average Costs, Marginal Costs, and Profits	Increasing Long-run Average Costs
	Decreasing Long-Run Average Costs

Competition for Rents	189	Technological Innovation	192
Why Might New, Entering Firms Have Higher Costs?		Entry and Exit or Expansion and Contraction	192
Who Gets the Rents?		Summary	193
Do Rents Serve Any Useful Purpose?		Discussion and Thought Questions	194
EXAMPLE 10.1	Entry in China	176	
EXAMPLE 10.2	Entry in the Camera Market, Circa 1982	177	
EXAMPLE 10.3	Entry in the Mail Order Catalog Business	178	
EXAMPLE 10.4	Do Capital and Labor Really Substitute for Each Other?	187	
EXAMPLE 10.5	Airline Deregulation and Entry	190	
EXAMPLE 10.6	Technological Change and the Cost of Electrical Power	191	
EXAMPLE 10.7	The Evolution of Computer Prices	194	

---

## **CHAPTER ELEVEN   Prices, Profits, and Competitive Markets   195**

---

Prices, Rationing, and Production		Competitive Markets and Allocative Efficiency	
Incentives	195	The Same Equilibrium Market Price for All Consumers	
An Increase in the Demand for a Commodity		The Same Equilibrium Market Price for All Producers	
A Decrease in the Demand for a Commodity		The Same Equilibrium Market Price for Consumers <i>and</i> Producers	
An Increase in the Costs of Producing a Commodity		Another Way of Looking at Allocative Efficiency	
Price and Profits		Technical Efficiency	
Prices and Profits: Market Information	202	Learning to Form Conclusions about Efficiency	
Prices and Information		Interesting Implications of Allocational Efficiency	
Profits and Information about the Allocation of Capital		Summary	216
Prices and Profits: Market Links	204	Discussion and Thought Questions	216
Arbitrage			
Efficiency	207		
Allocation Efficiency			
EXAMPLE 11.1	Market Linkages	196	
EXAMPLE 11.2	Producing Substitutes in Labor Markets	198	
EXAMPLE 11.3	Oops!	206	

---

## **CHAPTER TWELVE   International Markets for Commodities and Currencies   218**

---

International Trade and Domestic Markets	218	Comparative Advantage Distortions	
The Effect of Imports on Domestic Markets		Imports, Exports, and the Markets for Foreign Exchange	225
The Effects of Changes in the World Price		The Market for Foreign Exchange	
The Supply of Imports		Appreciation of the Dollar	
The Effect of Imports		Depreciation of the Dollar	
The Effect of Changes in the World Price		The Effects on Other Currencies	
The Demand for Exports			
Efficiency			

Import Prices and the Foreign Exchange  
Market  
The Trade Deficit  
Why Do Foreigners Hold U.S. Dollars?

Purchasing Power Parity  
Summary 235  
Discussion and Thought Questions 236

EXAMPLE 12.1	Foreign Competition and the Domestic Automobile Industry	228
EXAMPLE 12.2	Free Trade?	230
EXAMPLE 12.3	Quotes in International Trade: The Sugar Case	231
EXAMPLE 12.4	Exchange Rate Calculations	232
EXAMPLE 12.5	Factors Affecting the Foreign Exchange Value of the Dollar	235

## **CHAPTER THIRTEEN Markets for Resources 237**

---

Markets for Labor 237	Expectations and Investment
The Supply of Labor	Discounting
Substitution and Income Effects	The Further in the Future, the Lower the Present Discounted Value
Elasticity of Supply	Changes in the Interest Rate
The Demand for Labor	Investment and the Interest Rate
Elasticity of Demand	Elasticity of Demand
A Market for Labor	Stocks, Bonds, Loans, and Investments
Why Do Wages Differ?	Supplying Financial Resources and the Interest Rate
Lack of Physical Mobility	Elasticity of Supply
Compensating Differentials	A Market for Financial Resources
Ability Differences	Why Do Interest Rates Differ?
Human Capital	Summary 266
Discrimination	Discussion and Thought Questions 267
Unions	
Markets for Capital 254	

EXAMPLE 13.1	Pigeons Have Backward-Bending Labor Supply Schedules	243
EXAMPLE 13.2	Aggregate Labor Supply and Wages	249
EXAMPLE 13.3	Productivity	250
EXAMPLE 13.4	Differences in Incomes Across Jobs	251
EXAMPLE 13.5	Problems with Mobility	255
EXAMPLE 13.6	Risks and Salaries	256
EXAMPLE 13.7	Are Higher Salaries Really Associated with More Productive Performance?	257
EXAMPLE 13.8	Present Discounted Value of BA Degrees	258
EXAMPLE 13.9	Unions and Wages	259
EXAMPLE 13.10	Do Unions Affect Wages?	261
EXAMPLE 13.11	Substitution in Resource Markets	262
EXAMPLE 13.12	The Decision Not to Build a Supersonic Transport	263
EXAMPLE 13.13	Owners, Managers, and the Market for Corporate Control	265

## **CHAPTER FOURTEEN Government-Imposed Market Distortions 268**

---

Price Ceilings 268	Innovations Around Price Ceilings
The Effects of a Price Ceiling	Long-Run Effects
The Problem of Rationing	Scarcity versus Shortage
Alternative Rationing Procedures	Efficiency
Reallocation	Price Floors 282

The Effects of a Price Floor	Income Tax
Surpluses and the Problem of Disposal	Excess Profits Tax
Innovations Around Price Floors	Subsidies 299
Long-Run Effects	The Effects of a Subsidy
Efficiency	Subsidizing Consumers Directly
Restrictions on Entry 288	Subsidizing Producers Directly
Why Restrict Entry?	Efficiency
Licensing	Who Gets the Subsidy?
Non-Price Competition	Long-Run Effects
Substitutes	Distortions of International Trade 303
Prohibited Activities	Tariffs
Taxes 294	Quotas
The Effects of a Tax on a Particular	Tariffs versus Quotas
Commodity or Resource	Other Non-Tariff Barriers
Who Pays the Tax?	Summary 307
The Government's Tax Revenue	Discussion and Thought Questions 308
Efficiency	
Long-Run Effects	
EXAMPLE 14.1 Price Controls and the Natural Gas Market 270	
EXAMPLE 14.2 Minimum Wages 272	
EXAMPLE 14.3 Are Minimum Wages Discriminatory? 273	
EXAMPLE 14.4 A Sticky Mess 274	
EXAMPLE 14.5 The Peanut Problem 275	
EXAMPLE 14.6 Shifting Supply to Maintain a Price Support, I? 276	
EXAMPLE 14.7 Shifting Supply to Maintain a Price Support, II? 277	
EXAMPLE 14.8 Restricting Entry into Financial Planning Services 278	
EXAMPLE 14.9 "A Sweet Deal for Kiwifruit" 279	
EXAMPLE 14.10 What Is an Entry Restriction Worth? 281	
EXAMPLE 14.11 Licensing Barbers and Entry Restrictions 282	
EXAMPLE 14.12 Entry Restrictions and Illegal Activities: The Cab Market 285	
EXAMPLE 14.13 Will Taxing Beer Save Lives? 290	
EXAMPLE 14.14 Who Pays the Social Security Tax? 191	
EXAMPLE 14.15 Import Quotas and the Automobile Market 294	
EXAMPLE 14.16 "Yes, We (Greeks) Have No Bananas" 303	

## **PART THREE Market Failure and the Misallocation of Resources: Problems of Efficiency and Fairness 310**

### **CHAPTER FIFTEEN Monopoly 312**

Market Power 312	Competition versus Monopoly 318
Marginal Revenue and Market Price 313	The Effects of Different Market Structures
Marginal Revenue Equals Market Price for a	Market Failure: Inefficiency
Competitive Firm	Barriers to Entry 320
When a Monopolist Increases Its Output,	Ownership of a Natural Resource as a
the Market Price Falls	Barrier to Entry
Marginal Revenue Is Less Than Market	Technological Barriers and a Natural
Price for a Monopolist	Monopoly
The Response of a Monopolist 318	Legal Barriers