

The background of the cover is a dark, textured surface with several bright, intersecting planes and light rays. A prominent vertical line runs down the center, with several diagonal lines crossing it. The light rays create a sense of depth and perspective, with some rays appearing to converge towards the top of the frame. The overall effect is a complex, geometric composition that suggests a modern or scientific theme.

Economics

W.H. LOCKE ANDERSON · ANN PUTALLAZ · WILLIAM G. SHEPHERD

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◀ University of Michigan ▶

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Preface

Teachers know, and their students soon learn, that economics is an evolving field. Yet the basic concepts are relatively stable. In this book we present those concepts, as they are shared and used by economists. We try to convey both the simple beauty of economic logic and the complex variety of its practical uses in the world.

Economics is exciting and important, but parts of it can also be puzzling and genuinely difficult to master. Some students approach economics as a duty: a hard subject that's sure to be dull and not very rewarding. Yet economists know it instead as a fascinating field, which can clarify an astonishing range of topics with a few tools.

To help students advance from reluctance to enjoyment, we present logic, facts, policies, and other materials both in good balance and in an effective sequence. We stress *logic* because economics is above all a connected set of logical concepts and hypotheses. But logic alone is not enough. We must also emphasize

the *matters of degree*, which good economists learn to judge carefully. Logic and degree—hypotheses and facts—are a two-sided theme for students to watch as they learn both to grasp the tools and to evaluate real conditions.

Beyond that, we have another paired goal for students: first, to learn economics as it is, but also to acquire a healthy skepticism about economists' work and advice. Because economics is a human creation, it involves human errors and contradictions. By learning this, students come to understand that economic knowledge always has gaps and soft spots as it evolves, and that it cannot accomplish all—or even half—of the tasks we ask of it.

This sort of sympathetic realism need not undercut students' motives to learn the analysis. Instead, by gently dispelling students' hopes of finding something that is infallible, it encourages them to take a sensible view of the whole world. This demystifying process can in turn make it easier to learn.

Students often resist this balanced treatment, asking instead just to be told what material they “have to learn.” We think that all students can learn both the basic ideas and the economist's skeptical, independent-minded approach. That is the spirit which we have tried to convey.

The text We have labored long to make this book short. Despite its substantial size, the volume is a compact presentation of principles and examples. Every line reflects difficult choices we have had to make about depth and detail. Our choices have been guided by three main goals. The first is to be *clear*, using plain English concisely. The second is to be *complete* on technical analysis, making sure that the prose is thorough, step by step. The third is to give sufficient *variety* of “real” illustrations and cases, showing readers the important practical uses of the concepts.

The format The order of topics has been carefully chosen to provide a progression from basic concepts to more advanced issues. After the three introductory chapters, we go directly to microeconomics, as is preferred by most teachers. Yet macroeconomics can readily be covered first instead, by going from Chapter 3 to Chapter 22, and later returning to Chapters 4 through 21.

Within each major part, the chapters proceed generally from fundamental analysis to more complex, applied, and policy-oriented issues. The whole sequence of topics allows for flexibility in emphasizing some topics or omitting others, even among sections within chapters.

Several chapters can be said to emphasize concepts and analysis, mainly Chapters 2, 4, 8, 9, 10, 14, 17, 24, 25, 26, 28, 29, and 31. Yet all of the chapters present important analytical material, and so we do not separate chapters cleanly between categories of “theory” and “applications.”

The book has been planned to fit the standard two-semester course sequence. It can also provide an excellent one-semester coverage by a careful selection of chapters. We suggest one possible chapter format at the end of the preface, but teachers' preferences for specific topics will vary.

Distinctive features Apart from its whole approach, we have built into the book a number of special features, large and small, including the following: Part I provides a thorough foundation of concepts and methods, rather than just an introduction. Special features beyond the standard topics include:

Chapter 1 Economic goals. The economic literature and the development of economics. The economist's approach.

Chapter 2 Microeconomic principles (opportunity cost, marginal conditions,

diminishing marginal effect, scarcity, equilibrium, public choice). Macroeconomic principles.

Chapter 3 The linkage of diagrams, hypotheses, and models. Organizing and presenting data. Stocks and flows.

Part II presents allocation analysis thoroughly and with unusual concern for general equilibrium.

Chapter 4 A focus on supply and demand concepts. Thorough treatment of elasticity.

Chapter 5 Supply and demand concepts and cases are knitted together; agriculture, oil prices, tax incidence, market controls. Measures of elasticities.

Chapter 6 Focuses on individual demand. Consumer surplus. An assessment of utility analysis.

Chapter 7 Uniquely thorough coverage of the enterprise. Actual patterns of firms. A tour of *Wall Street Journal* data. Nonprivate firms. Accounting, motives, and success indicators. A case study of starting up a firm.

Chapter 8 Intensive coverage of cost analysis. Link between productivity and cost. Economies of scale.

Chapter 9 The nature of competition, marginal cost, and efficiency conditions.

Chapters 10–13 cover monopoly power and its policy remedies with an industrial-organization focus.

Chapter 10 Varieties of markets, from pure monopoly to pure competition. Concise causes and effects of monopoly. Case studies of monopolies. Price discrimination fully explained.

Chapter 11 The dominant-firm case. Numerous practical instances, includ-

ing newspaper markets. The Schumpeterian process. The contrast between tight and loose oligopoly. New data on the rise in competition since 1960.

Chapter 12 Antitrust agencies, trends, and criteria. A detailed presentation of cases and their economic effects.

Chapter 13 The economic content of regulation. Commissions and their setting. Key economic issues: marginal cost pricing, inefficiency, and deregulation. Public enterprise: its coverage and economic criteria.

Next come inputs and general equilibrium in Chapters 14–17. Both labor and capital are given detailed attention.

Chapter 14 Thorough analysis of input choices. Economic rent. Inputs' roles in creating value.

Chapter 15 The utility basis of work choices. Human capital and returns to education. Effects of labor unions.

Chapter 16 Uniquely thorough, integrated coverage of capital (physical and portfolio) and technological change. Investment choices, cost of capital, return to capital; risk and asset values. Expectations and stock prices. Stock markets as the control system of capitalism. Trends and elements of technological change.

Chapter 17 Complete coverage of equilibrium and allocation. Ripple effects and input-output tables. Limits on the invisible hand.

We round out microeconomics by analyzing major public policy choices in Chapters 18–21.

Chapter 18 A thorough analysis of social goods, external effects, and cost-

benefit analysis. Taxes and incentive effects. Trends of taxes and spending.

Chapter 19 Trends and causes of inequality. Analysis of discrimination. Actual incidence of taxes and spending.

Chapter 20 Analysis of resource conservation: criteria and free-market efficiency. Common-property resources. Agriculture, the energy sector, and future world resource scarcities.

Chapters 22–33 survey macroeconomic and monetary analysis. They contain a thorough, careful exposition of the standard theoretical tools, extensive historical instances of their application, and numerous unique features.

Chapter 22 Trends in output and prices. Fluctuations in employment. The growing federal government share. Stock prices and the business cycle. The pervasiveness of cyclical fluctuations.

Chapter 23 Visualizing the economic system as a whole. National accounts. Value added, final demand, and gross national income. How the input-output structure ties industries together. Sectoral receipts and expenditures. Price indexes and real output.

Chapter 24 The consumption function. Planned and unplanned investment. Business saving. Equilibrium in a two-sector economy. How the government and foreign sectors fit in.

Chapter 25 The multiplier as theorem, process, and number. Expansion and contraction in a two-sector economy. The four-sector economy. Limits, uses, and misuses of the multiplier.

Chapter 26 Cost push, input prices, and productivity. Final demand, GNP, and input markets. The Phillips curve. Persistent inflation. Expectations. The

shifting Phillips curve. (The role of money in the inflationary process is deferred to Chapter 29.)

Chapter 27 An introduction to money and monetary institutions. Definitions of money. Financial assets. Commercial banks, thrift institutions, and security markets. The flow of funds.

Chapter 28 The creation of bank money. The Federal Reserve and the banking system under the 1980 banking law. Assets and liabilities of the Fed and the banking system. How banks expand and contract the money supply. Open market operations and their impact on the monetary base. Reserve requirements. Federal Reserve lending.

Chapter 29 The level and structure of interest rates. How interest rates affect the velocity of money. The equilibrium interest rate. How the Fed influences interest rates. Interest rates and final demand. The monetary feedback. The Keynesian-monetarist debate in detail. Money and inflation. The real rate of interest. Is money neutral?

Chapter 30 The institutional framework of stabilization policy. Potential GNP, the gap, unemployment, and inflation. Costs of falling short of potential. Costs of exceeding potential. Persistent inflation again. Indexing. Direct controls. Strategies of stabilization policy: rules versus discretion.

Chapter 31 Fiscal and monetary policy in action. The federal budget. Built-in stabilizers. Interpreting the federal deficit. The national debt: Who owns it? The burden of the debt. How monetary policy is conducted. Controlling the money supply versus controlling interest rates. Policy coordination and conflict.

Chapter 32 The history of stabilization policy under the Kennedy, John-

son, Nixon, Ford, Carter, and Reagan administrations, with particular emphasis on the relative impacts of fiscal and monetary changes.

Chapter 33 An historical approach to American economic growth. Demographic changes and their effects on growth. Capital accumulation and technical change. Agriculture and industry.

Chapters 34–37 turn outward. They cover the theory and practice of international trade and finance, and the problems of Third World development in a world dominated by developed countries.

Chapter 34 Comparative advantage. The gains from trade and their relationship to demand. The pattern of world trade. Protectionism: tariffs and quotas. The case for protection. Export restrictions. The OPEC cartel. Recent U.S. trade history. Comparative advantage and the pattern of U.S. trade.

Chapter 35 International exchange markets. The balance of payments: current and capital accounts. Determination of exchange rates in the current institutional context. The gold standard and the Bretton Woods system versus the system of floating exchange rates.

Chapter 36 What is economic life like in the Third World? Contrast between the Third and First Worlds. Why is the Third World underdeveloped? Capital, population, education, subsistence agriculture, colonial history. Underdevelopment and international trade. Specialization in primary products. Development strategy. Import substitution versus export promotion. The question of foreign aid.

is predominantly Marxist. Chapter 37 presents some of the main elements of the Marxist critique of capitalism. Chapter 38 describes Marxist economic practice in the Soviet Union and China.

Chapter 37 Value and surplus value. The origin of the surplus. Transformation of the surplus into capital. Forces and relations of production. The class structure of capitalism. The reserve army. Capitalist crises. Contradictions and the collapse of capitalism.

Chapter 38 The Russian Revolution. Early failures and successes of socialism. Stalinism, collectivization, and forced industrialization. The structure of the modern Soviet economy. Planning and efficiency. Is Russia socialist? The Chinese Revolution. Reconstruction. The Great Leap. Transformation of the forces of production versus transformation of the relations. The Cultural Revolution. The future of China.

Throughout, there are “boxes” presenting unusual topics, special cases, or extended discussions. Also, each concept is printed in boldface type when it is first presented, and definitions of the concepts are gathered in a glossary at the back of the book.

Teaching aids Each chapter begins and ends with a brief summary of its main points. End materials also include a list of key concepts in the chapter, plus questions for review.

To complement this textbook, there is a set of additional materials: The *Study Guide* (which, along with the test bank, was written by Ann Putallaz with the assistance of Therese Mendola) is designed to help students identify and resolve areas of confusion, and to develop their ability to

Throughout much of the world, economics

apply theoretical concepts in solving problems. For each chapter, true-false and multiple choice questions and applied problems are presented. The questions focus on concepts with which students frequently have difficulty. Detailed explanations of answers to the questions are provided to ensure that students do not answer a question correctly without understanding why it is correct, and that they are not unduly frustrated by having answered a question incorrectly and not knowing why. The problems help students learn to apply theoretical concepts correctly. Students who work with the study guide will be able to identify sources of confusion, and can build confidence in their ability to apply the material through problem solving. Throughout, an attempt is made to keep students' attention focused on core material, and to encourage them to feel at ease with the subject matter.

The *Test Bank* (available only to instructors) contains multiple choice questions for each chapter. The questions vary considerably in difficulty. Within each chapter, questions are generally arranged sequentially according to the location of the relevant material in the text. Frequently, more than one question is available for a given topic to allow instructors flexibility in designing tests. The test bank is stored in a computer file so that the publisher can provide instructors with individually tailored semester exams. The procedure for ordering these exams is described in the introduction to the *Test Item File*.

The *Instructor's Manual* (prepared by the authors and available only to instructors) is written with the needs of the instructor in mind. It emphasizes the goals of the text, chapter by chapter, and calls the instructor's attention to crucial concepts and diagrams and to areas that students may find particularly difficult. It also gives answers to selected review ques-

tions that appear at the end of the text chapters.

A *Transparency Package* containing the most important analytical diagrams is also available from Prentice-Hall.

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We are deeply indebted to many people for supporting us in shaping this book. For special help from our colleagues at the University of Michigan we want to thank Alan Deardorff, Richard Porter, and Gavin Wright. Our teaching fellows have also given good advice from their classroom experience with the book.

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Finally, our children have sacrificed to make this book possible, by doing without our attention from time to time. We thank them, too, with hopes that they will some day learn from reading it for themselves.

One possible format for a one-semester course

Chapters

- 1 The Economic Approach
- 2 Basic Economic Principles
- 3 Methods and Measurements

- 4 Demand and Supply
- 5 Demand and Supply in Action
- 8 Supply: The Nature of Costs
- 9 Pricing and Output Under Perfect Competition
- 10 Monopoly
- 11 Degrees of Competition
- 14 Input Markets
- 17 General Equilibrium
- 22 An Introduction to Macroeconomic Analysis
- 23 National Product and Income
- 24 Equilibrium of the Circular Flow
- 25 The Multiplier
- 26 Unemployment and Inflation
- 27 Financing the Circular Flow
- 28 Banks and Money Creation
- 29 Money, Interest, and GNP
- 30 The Institutions, Goals, and Strategies of Stabilization Policy
- 31 Fiscal and Monetary Policy
- 32 Stabilization Policy: The Historical Record

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Contents

Preface, xxix

PART ONE: INTRODUCTION

◀ 1 ▶

The Economic Approach, 1

Economic Systems, 1

Scarcity and Choice, 2 Economic Goals, 3 Positive
and Normative Economics, 4

Economic Analysis, 7

Early Economic Thought, 7 Classical Economics, 8 Neoclassical
Economics, 8 The Literature, 12 Schools and Groups, 13
The Economic Approach: Matters of Logic and Degree, 13

Summary, 14

Key Concepts, 15

Questions for Review, 15

◀ 2 ▶

Basic Economic Principles, 17

The Economy as a System, 18

Households: The Decision Units for Selling Inputs and Buying Goods, 19 Enterprises and Inputs, 20 Maximizing Behavior, 21
Market Exchange, 22 The Circular Flow, 23

Microeconomic Principles, 24

Opportunity Cost, 25 Marginal Conditions, 25
Diminishing Marginal Effect, 26 Efficiency and Scarcity:
The Production Possibility Boundary, 27
Equilibrium, 31 Public Choice, 32

Macroeconomic Principles, 33

The Circular Flow, 33 Income and Output, 34
Demand and Income, 34 Changes in Output, 35
Potential Output, 35 Stabilization Policy, 36

Summary, 37

Key Concepts, 37

Questions for Review, 37

◀ 3 ▶

Methods and Measurements, 39

Diagrams and Their Use, 40

Linear Equations and Their Graph, 41 Economic Models, 44
Time Series, 48 Distributions, 49

The Interpretation of Numbers, 50

Problems of Bias and Deception, 50 Stocks and Flows, 51

Summary, 53

Key Concepts, 54

Questions for Review, 54

PART TWO: MICROECONOMICS

◀ 4 ▶

Demand and Supply, 55

Demand, 58

Influences on Demand, 58 The Demand Curve, 59 Quality Demanded and Demand, 61 Price Elasticity of Demand, 63 Elasticity and Total Revenue, 66 Determinants of the Price Elasticity of Demand, 67 Income Elasticity of Demand, 67 Cross-Elasticity of Demand, 70

Supply, 71

Influences on Supply, 71 The Supply Curve and Its Upward Slope, 72 Quantity Supplied Versus Supply, 73 Elasticity of Supply, 75 Determinants of Elasticity of Supply, 77

Interaction of Supply and Demand, 78

Summary, 81

Key Concepts, 83

Questions for Review, 83

◀ 5 ▶

Demand and Supply in Action, 85

Effects of Elasticities on Market Outcomes, 86

Elastic Demand and Supply, 86 Inelastic Demand and/or Supply, 87 The Price of Oil, 90

Interferences with the Market Process, 91

The Burden of a Sales Tax, 91 Price Controls, 94 Controls on Quantity, 97

Measuring Supply and Demand, 98

Summary, 101

Key Concepts, 102

Questions for Review, 102

◀ 6 ▶

Individual Demand, 103

The Analysis of Utility and Demand, 104

Rational Choices by Consumers, 105 Diminishing Marginal
Utility, 107 Individual Demand Curves: Preferences and Income, 110
Scarce Goods and Free Goods, 111 Marginal Utilities and Prices
in Equilibrium, 113 Shifts Versus Movements Along Demand Curves, 116
Consumer Surplus, 117 Market Demand Is the Sum of Individual
Demands, 118 Derived Demand, 120

The Validity of Demand Analysis, 120

Summary, 121

Key Concepts, 122

Questions for Review, 122

◀ 7 ▶

The Enterprise, 123

Patterns of Actual Enterprises, 124

Private Enterprises, 124 Other Types of Firms: Public Enterprises,
Nonprofit Firms, and Cooperatives, 135

The Enterprise, 135

Choices and Outcomes, 136 Inputs, Outputs, and
Production, 137 Simple Accounting, 138 Success Indicators:
Profitability and Stock Prices, 141

A Case Study: Starting a New Enterprise, 142

Choosing What to Produce, 142 Starting, 143 Lessons, 144

Summary, 145

Key Concepts, 145

Questions for Review, 146

◀ 8 ▶

Supply: The Nature of Costs, 147

Basic Concepts:

Technology, Opportunity Cost, and Economic Profit, 148

Technology, 148 Opportunity Cost, 149 Economic Profit, 151

Productivity and Costs in the Short Run, 153

Short Run and Long Run, 153 Productivity in the Short Run, 153 The Law of Diminishing Marginal Returns, 157 Costs in the Short Run, 158

Productivity and Costs in the Long Run, 163

Derivation of the Long-Run Average Total Cost Curve, 164 Economies of Scale: The Shape of the Long-Run ATC Curve, 167 The Marginal Conditions Necessary for Least-Cost Production, 171

Summary, 173

Key Concepts, 174

Questions for Review, 175

◀ 9 ▶

Pricing and Output Under Perfect Competition, 177

The Rules for Maximizing Profits, 178

Should the Firm Produce at All? 178 How Much Should the Firm Produce? 178

Setting Output Under Perfect Competition, 180

The Nature of Pure Competition, 180 Competition: A Process and a Zone of Choice, 180 Rivalry and Pure Competition May Give Similar Results, 181 Firm and Market Demand in Perfect Competition, 181 Marginal Cost, 182 The Firm's Short-Run Supply Curve in Perfect Competition, 183 A More Complete Analysis, 184 The Short-Run Market Supply Curve Is a Summation, 188 Shifts in the Firm and Industry Supply Curves, 189 Short-Run and Long-Run Equilibrium in Perfect Competition, 190

Long-Run Supply, 193

The Firm's Long-Run Supply Curve, 193 The Long-Run
Market Supply Curve, 194

Efficient Allocation Under Competition, 194

Summary, 196

Key Concepts, 197

Questions for Review, 197

◀ 10 ▶

Monopoly, 199

Varieties of Monopoly and Competition, 200

Monopoly and Its Effects, 200

The Characteristics of Monopoly, 200 How Monopoly Power Is Created
and Maintained, 203 The Effects of Monopoly Power, 204
Price Discrimination, 213

Cases of Monopoly, 216

Standard Oil, 217 Electric Companies, 217

Summary, 218

Key Concepts, 218

Questions for Review, 219

◀ 11 ▶

Degrees of Competition, 221

The Dominant Firm, 222

Definition of Dominance, 222 Instances and Effects of
Dominance, 223 Possible Causes of Dominance, 224

Oligopoly, 229

Concentration and Leading Firms, 229 Conflicting Incentives Can Make
Oligopoly Unstable, 232 Types of Collusion, 234 The Central Tendency
Under Oligopoly, 235 Rigid Prices: Kinked Demand
Curves, 236 Economies of Scale: A Cause of Oligopoly? 239

Monopolistic Competition, 240
Patterns and Trends in Real Markets, 241
 Aggregate Concentration, 241 Concentration in Individual
 Markets, 242 Conglomerate Firms, 244

Summary, 246
Key Concepts, 247
Questions for Review, 247

◀ 12 ▶

Policies Toward Monopoly Power: Antitrust, 249

Origins and Standards of U.S. Antitrust Policies, 250
 Three Waves, 250 Standards of Efficient Policies, 252

U.S. Antitrust: Forms and Coverage, 253
 The Agencies and Laws, 253 History, 254 Antitrust
 Criteria, 256 Precedents, 257 Mergers, 258 Economic Effects, 258

Specific Parts of Antitrust, 259
 Antitrust Actions Toward Existing Concentration, 259 Antitrust Policies
 Toward Mergers, 264 Policies Toward Price Fixing
 and Other Actions, 267

Summary, 269
Key Concepts, 270
Questions for Review, 270

◀ 13 ▶

Policies Toward Monopoly Power: Regulation and Public Enterprise, 271

Regulation of Utilities, 272
 Patterns of Regulation, 272 Decisions on Price Levels and
 Structures, 275 Four Economic Issues of Regulation, 277