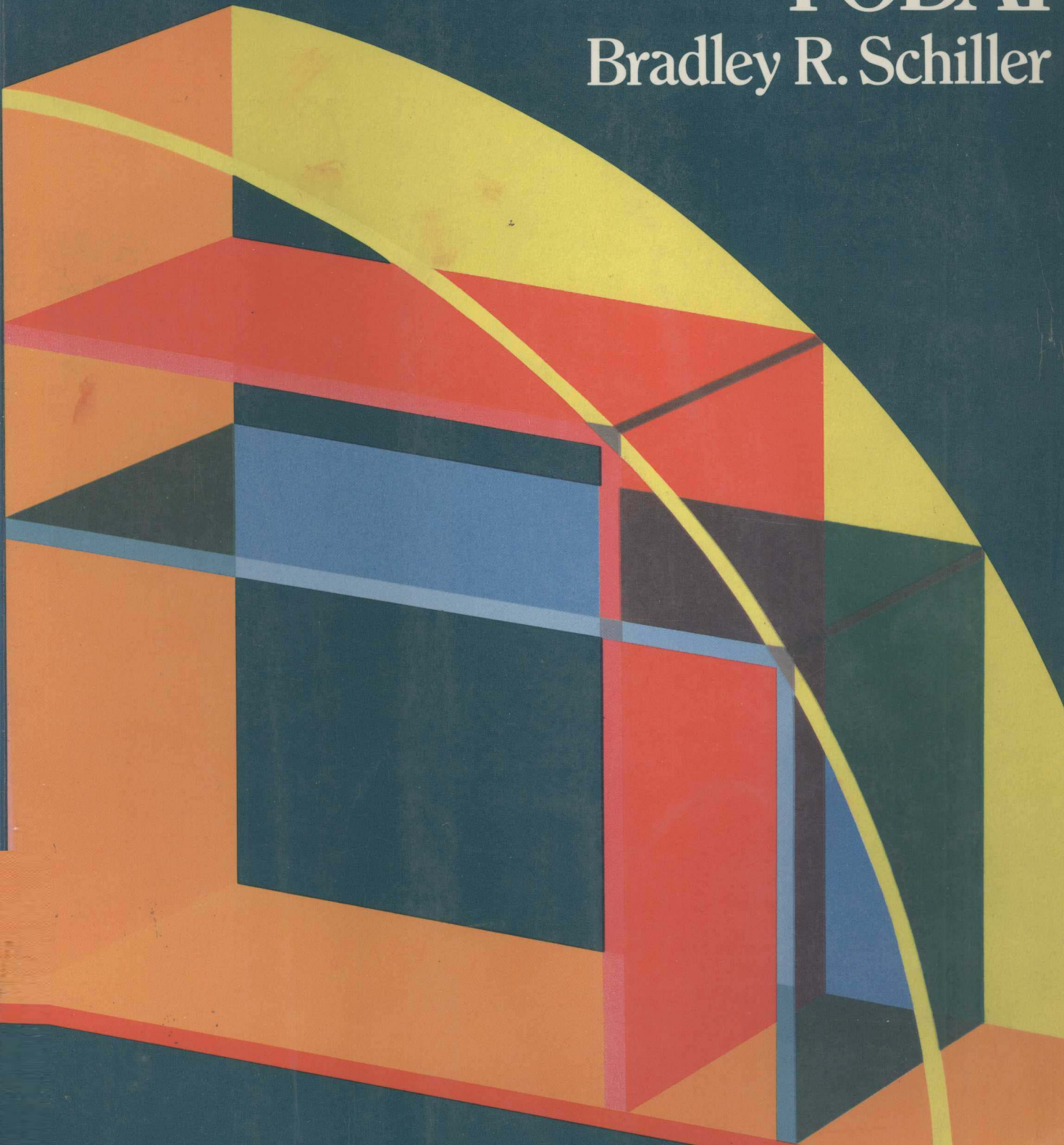


THE MICRO ECONOMY TODAY

Third Edition

Bradley R. Schiller



THE MICRO ECONOMY TODAY

THIRD EDITION

BRADLEY R. SCHILLER

The American University



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PREFACE

At first blush, microeconomics seems so much less important than macroeconomics. Micro is concerned, after all, with the decisions and behavior of individual workers, families, firms, and markets. Macro, on the other hand, focuses on the big picture—the collective (aggregate) behavior of all market participants. The great policy debates all seem to be about the macro problems of inflation, unemployment, and economic growth. In this context, knowledge of individual decision making seems so much less significant than an understanding of our collective behavior.

This first impression is highly misleading, however. To begin with, microeconomics is the foundation of all macroeconomics. Macro outcomes are the result of millions of individual decisions. If these decisions are not understood, then knowledge of macroeconomics is necessarily incomplete. The result may be bad macro policy. The situation is much like driving a car. Most of the time you can get along just knowing the (macro) principles of accelerating, steering, and braking. But when something goes wrong, you need to know how the car really works. Why did it fail to accelerate or slow down on time? Why is it veering off the road? To answer these questions, someone must look under the hood.

Recent debates about supply-side economics have encouraged more people to look under the economy's hood. The emphasis of supply-side economics is on individual decision making. Supply-siders argue that greater incentives are the key to increased work effort, more savings and investment, and greater productivity. From the supply-side perspective, improved macro outcomes—particularly less unemployment and

inflation—are possible only if these micro incentives are included in the design of economic policies.

Not everyone accepts the supply-side prescriptions for macro problems. But there is now a much greater recognition of the role micro behavior plays in macro outcomes.

Microeconomics is also important in its own right. The well-being of individuals is of direct concern to society, independently of macro implications. Two societies, identical in every other respect except their different distributions of income, are not viewed similarly. People *do* care about the distribution of income, even in the absence of macro problems. This concern is manifest in continuing debates about tax reform, budget cuts, welfare programs, and recent changes in Social Security. The reason these debates are so intense and so protracted is that no one wants a smaller slice of the economic pie.

This text seeks to satisfy two related goals. First, it tries to convey the dimensions of our microeconomic problems. For example, the distribution of income is described before the trade-offs between equity and efficiency that redistributions may involve are examined. The nature and severity of pollution are assessed before the economic incentives to pollute are analyzed. Likewise, the nature and extent of profits are described before the text examines the forces and decisions that create profits. And a whole chapter is devoted to examples of market power that illustrate the principles of monopoly, oligopoly, and monopolistic competition.

The justification for this descriptive material is the notion that you must get a person's atten-

tion before you can teach anything. That notion leads to the second goal of the text: to teach the basic principles of microeconomics. Writing style and topical illustrations facilitate the goal. In addition, however, the text provides clear, step-by-step development of basic concepts. Instead of being encyclopedic, the text concentrates on the exposition of core principles. The aim here is to teach economic principles in a way that maximizes retention—through the use of real-world examples, basic concepts, and careful, readable explanations.

REAL-WORLD FOCUS

The Micro Economy Today is developed around real-world events. The core of the text is the microcomputer industry, used as a recurrent example. The excitement begins with the story of the Apple I—its simplicity, its low cost, and its humble origins in Steven Jobs's garage. Then the microcomputer revolution springs forth, with Apple, Inc. in the lead and hundreds of upstart firms and established megacorporations chasing after the phenomenal profits Apple discovered. In only a few years' time, the microcomputer industry gets so crowded that prices and profits tumble. The crossroads are reached in 1981, when the industry splits in two. One pack of firms takes the "low road" toward "home" computers; the rest of the microcomputer firms pursue profits on the "high road" of "personal" computers. Ultimately, competition becomes so intense in both markets that the rate of exit from the industry in the period 1981–85 nearly matches the entry rate in 1978–81.

The microcomputer story is one of the most dynamic business sagas of the last decade. In this edition, the student gets a bird's-eye view of every phase of that story—not just as an afterthought, tucked away in a little box, but instead as an integral part of the presentation. Indeed, the microcomputer story is the story of how competition works. In Chapter 7 that story is used to introduce, illustrate, and reinforce the principles of competition. Subsequent chapters continue the tale, showing how and why established firms try to avoid such intense competition. No one can read Chapter 7 without acquiring an appreciation of the competitive process.

BASIC OBJECTIVES OF THE TEXT

The core "story" of this edition—the dynamism of the microcomputer market—reflects the basic orientation of *The Micro Economy Today*. The first objective is to teach the basic principles of economics in a clear and accurate fashion. The second objective is to stimulate student interest so that students want to learn those principles. This stimulus is provided by the world around us. The simple proposition that you can't teach someone until you get their attention, remains the maxim for *The Economy Today*. The travails of the fictional ABC Company trying to wring profits from widget production rarely rivet anyone's attention, but the real-life stories in *The Micro Economy Today* just might spark student interest.

CONTENT OF THE TEXT

As in earlier editions, this third edition of *The Micro Economy Today* introduces, explains, and illustrates basic micro principles with an abundance of real-world stories. This time around, the stories are "hotter" than ever, and some entirely new topics—tax reform, deregulation, the farm crisis, and productivity of the firm—have been added.

The Basics

The first chapter of the core micro section (Chapter 4) explores the nature and determinants of consumer demand. The elasticity discussion has been strengthened, and an appendix on indifference curves has been added.

Chapter 5 explores the cost structure of a firm, emphasizing the relationship of real resource utilization to dollar costs. This chapter gives students a solid grasp of the basic cost curves, especially their determinants and interrelationships.

Profits and the supply decision are the focus of Chapter 6. The sharply differing notions of profit held by the public, by accountants, and by economists are discussed. This discussion is important in spotlighting the unique nature of "economic profit," the key attraction of dynamic markets. The actual profits and losses of well-known corporations are also noted, along with (distorted) public perceptions of profit rates. The chapter

also introduces the basic parameters of profit-making production decisions.

The Competition Sequence

As noted earlier, the core of the micro section is the story of the microcomputer industry. The simplicity of the Apple I and its financing makes it easy for students to see how a firm can get started. The phenomenal growth of sales and profits makes the process exciting. Then comes the competitive profit squeeze, as scores of firms start chasing the early winners. As profits disappear and firms shut down and exit the field, the critical functions of easy entry and economic profits are highlighted.

Chapter 7 presents the basic computer story. The story is adapted in Chapters 8 and 9 to show how barriers to entry impede competition. Explicit comparisons between monopoly and competition (see p. 215, for example) emphasize how differences in industry structure affect industry outcomes. The same emphasis on economic outcomes is apparent in the discussion of oligopoly and monopolistic competition.

As in earlier editions, this third edition of *The Micro Economy Today* devotes an entire chapter (10) to illustrations of market power in the U.S. economy. These examples highlight the various sources of market power (such as patents and control of distribution channels) and the behavioral patterns (such as price fixing and price discrimination) that exploit it.

Productivity of the Firm

An entirely new chapter (11) looks inside the firm to see how resources are actually managed. Economists tend to assume that the firm always operates at maximum efficiency (that is, at a point on the production function), without worrying about whether or how such efficiency is actually attained. The people who run factories and manage offices cannot afford such a luxury. They must look closely at actual costs and try to reduce them. This requires effective management techniques. Chapter 11 reviews these internal productivity problems and some management techniques for solving them. The “secrets” of the honors list of firms in Peters and Waterman’s *In Search of Excellence* are revealed, along with suggestions from Theories X, Y, and Z. This chapter should be most

useful to business students looking for more linkages between their economics and business courses.

The Farm Crisis

Outside the Farm Belt, few people realize how severe the farm problem has become in recent years. Between 1970 and 1983, farm incomes fell faster and further than between 1929 and 1933. Moreover, real farm income was lower in 1983 than in 1933. An entirely new chapter (12) is devoted to an examination of this “Second Depression” in farming, first describing its magnitude and then assessing its causes. Although federal farm policies leave much to be desired, the prime causes of the farm downturn have been high interest rates and a strong dollar. These factors are discussed, along with the political squabbling over whether and how to prop up farm incomes.

Deregulation

Another new chapter examines the deregulation movement. In recent years, government regulation has been on the defensive, and has actually been reduced in many industries. Chapter 14 begins with a review of the arguments for government intervention, then examines some of the problems inherent in price, profit, or output regulation. The actual effects of deregulation in railroad, trucking, telecommunication, and air travel are then surveyed.

The Labor Sequence

The Micro Economy Today continues to offer a complete sequence on labor, including separate chapters on labor supply, labor demand, and collective bargaining. It is shocking to see how many principles texts devote only a page or two to labor supply and provide only superficial treatment of collective bargaining. With wages and salaries accounting for nearly three-fourths of national incomes, such neglect is inexplicable. In Chapter 15, the multidimensional determinants of labor supply are discussed and the labor-supply decision is analyzed. The institutional constraints on optimal supply decisions are also noted. Those decisions are further explained in the context of public welfare rules and benefits in Chapter 20.

In Chapter 16 the determinants of marginal

revenue productivity are explored, and are used to explain why “Marvelous” Marvin Hagler was paid more than \$1.25 million *per minute* for his 1985 middleweight championship fight. Chapter 17 describes the collective-bargaining process, with illustrations such as the 1984 General Motors–United Auto Workers accord and the short-lived baseball strike of 1985.

Tax Reform

Tax reform has been near the top of the policy agenda for well over a year. If nothing else, it successfully diverted attention from budget deficits and potential tax increases. But tax reform is basically a micro issue—a policy decision to redistribute incomes and alter production decisions. Chapter 19 examines the major tax-reform proposals from this perspective. The chapter begins with a description of the income distribution, then examines the role of taxes in shaping it. The horizontal and vertical inequities of the tax system are also noted. The chapter then describes the 1985 Reagan tax-reform proposals and assesses their potential impact.

International Topics

The final section of the text focuses on international subjects. International trade and finance receive substantial attention, in recognition of their growing influence on our economic performance. In each case, the motivations for trade and finance are discussed at length. The market mechanism is then related to those motivations. Finally, the sources of resistance to free trade and finance are identified as constraints on policy decisions. In the process, David Ricardo’s theories and vested economic interests are both viewed as important determinants of trade flows. One story about Franco-American trade in wheat and wine weaves through the trade and finance chapters, helping to drive home the intrinsic relationships of trade and finance.

STUDENT LEARNING AIDS

It is hoped that the style and approach of *The Micro Economy Today* will motivate students to learn microeconomics. Motivation is not enough, however. A text must also “teach” basic princi-

ples. In this regard, the core theory chapters of the text cover the standard topics of micro theory, in familiar order. The learning process is reinforced by the following features.

Textual learning aids

To facilitate comprehension and retention, each chapter contains the following learning aids:

CHAPTER PREVIEW Each chapter begins with a narrative introduction to the content and purpose of the chapter. Each preview highlights basic questions to be answered and relates them to previous chapters.

RUNNING GLOSSARY Definitions of key terms are provided in the margins, to facilitate retention and quick review. Definitions are repeated in successive chapters where they are relevant, in recognition of the fact that students do not always remember basic terms after only one “lesson.” All of these terms are compiled into a complete glossary, with chapter references, at the end of the book.

FULLY ANNOTATED GRAPHS AND TABLES All graphs and tables in the text are accompanied by self-contained captions. These reinforce the in-text discussions and facilitate quick review. In addition, the contents of related schedules and graphs are explicitly synchronized with the aid of labeled rows (in schedules) and dots (on graphs). The demand schedule and curve in Chapter 2 illustrate this feature. Color is used in tables and graphs throughout to highlight new or important concepts.

SELF-CONTAINED EXAMPLES The text makes considerable use of shaded boxes to illustrate key points of the text. Some of these are designed to highlight a basic concept (such as *ceteris paribus*). Others are illustrative digressions in the form of reprints of newspaper and magazine clippings, results of public-opinion polls, or short summaries of related material. The use of shaded boxes clearly distinguishes all of this material from the flow of the basic text.

POLICY IMPLICATIONS Every theory chapter contains a brief discussion of a specific policy implication. These sections reinforce the basic theoretical presentations by underscoring the use of the principles introduced in the chapter.

NARRATIVE SUMMARIES Chapter summaries highlight basic points and principles in brief, sequenced paragraphs.

KEY-TERM REVIEW Each chapter ends with a list of key terms for quick review. These lists include all terms in the running glossary of the chapter.

DISCUSSION QUESTIONS Four or five discussion questions are provided at the end of each chapter. These relate directly to basic principles covered in the chapter and can be used for student review, class discussion, or homework assignments.

NUMERICAL PROBLEM Most chapters conclude with one numerical problem. This tests the student's ability to solve typical exam-type problems. Answers are in the *Instructor's Resource Manual*.

Study Guide

There are several supplements available to accompany the text itself. From the student's perspective, the most important of these is the *Study Guide*, prepared by Professors Michael Tansey at Rockhurst College and Lawrence Ziegler at the University of Texas (Arlington). Each chapter of the *Study Guide* contains these features:

QUICK REVIEW Key points in the text chapter are restated at the beginning of each *Study Guide* chapter. The reviews are parallel to and reinforce the chapter summaries provided in the text.

LEARNING OBJECTIVES The salient lessons of the text chapters are noted at the outset of each *Study Guide* chapter. These objectives focus the student's study and help to ensure that key points will not be overlooked. The objectives are keyed to the exercises in the *Study Guide* to help reinforce learning.

KEY-TERM REVIEW Early in each chapter the students are asked to match definitions with key terms. This relatively simple exercise is designed to refresh the student's memory and provide a basis for subsequent exercises.

TRUE-FALSE QUESTIONS Twenty or so true-false questions are provided in each chapter. These questions have been class-tested to ensure their effectiveness in highlighting basic principles.

MULTIPLE-CHOICE QUESTIONS Approximately fifteen multiple-choice questions per chapter are provided. These questions allow only one correct answer and also focus on basic principles.

PROBLEMS AND APPLICATIONS There are more than forty new exercises in the *Study Guide*, most of which stress current issues and events. The exercise on farmland prices (Chapter 12) illustrates micro principles well.

COMMON ERRORS In each chapter of the *Study Guide*, errors that students frequently make are identified. The bases for those errors are then explained, along with the correct principles. This unique feature is very effective in helping students discover their own mistakes.

ANSWERS Answers to *all* problems, exercises, and questions are provided at the end of each chapter. Difficult problems have annotated answers. These answers make the *Study Guide* self-contained, thus allowing students to use it for self-study.

Microcomputer Simulations

New to this edition is a set of three microcomputer simulations in microeconomics by Rae Jean Goodman of the U.S. Naval Academy, on supply and demand, market power (in the microcomputer industry) and price/output decisions. These simulations put the student in the role of decision makers in various industries and firms. Students will gain experience deciding which information is most important in micro policy making.

Computerized Graphics Tutor

A program for the IBM-PC has been prepared by William D. Gunther, of the University of Alabama, to help students understand key microeconomic concepts through the use of interactive graphic presentations.

INSTRUCTOR'S AIDS

We have tried to make the learning process easier for teachers as well as students. To this end, Professors Virginia Owen and Alan Dillingham (Illinois State University) have prepared an *Instructor's Resource Manual*.

tor's *Resource Manual*. In addition, Professor Michael Ellis (Texas Wesleyan College) has compiled an updated *Test Bank* of more than 2,500 multiple-choice questions.

Instructor's Resource Manual

The purpose of the *Instructor's Resource Manual* is to provide a ready source of lecture and discussion material for classroom teaching. To this end, it offers a variety of material, including:

CHAPTER OUTLINE The first section of each chapter briefly summarizes the material under the text's major headings. Instructors can duplicate this section for students as an aid in studying.

TEXT EXPANSIONS The second section of each chapter highlights subjects that often require special attention, giving many interesting examples for classroom discussion.

CONTROVERSIAL ISSUES The third section of each chapter, "Take a Stand," describes a controversial issue associated with the theory presented in the text. Chapter 2 of the text, for example, discusses the basic elements of supply and demand. The *Resource Manual* discusses the pros and cons of taxing imported refined gasoline, drawing on the text and a recent news article. No resolution of the issue is offered. "Take a Stand" is intended to start a classroom discussion or to form the basis for essay-type questions.

NEWS UPDATE The fourth section of each *Resource Manual* chapter provides a summary and analysis of a recent economics event. The core of the "News Updates" is drawn from *The Wall Street Journal*, *Business Week*, or similar publications. The news summary is supplemented by a brief analysis that ties the story directly to the content of the text.

SUPPLEMENTARY RESOURCES The final section in each chapter serves two separate functions. First, it provides a list of audio-visual and printed materials that can be readily obtained for class use. Second, it provides references for additional lecture material or student assignments.

Test Bank

A completely new *Test Bank* was prepared for this edition. The *Test Bank* includes: 39 chapter tests of approximately 65 multiple-choice questions per chapter, totaling 2,510 questions. Each question has been classified according to its level of difficulty. There are three levels. The first requires the simple recall of facts, names, or definitions. The second level of question is analytical, requiring greater comprehension and an understanding of functional relationships. The third level, the most difficult, demands a thorough comprehension of theory and a high degree of analytical reasoning.

About half of the *Test Bank* questions are cross-referenced directly to the learning objectives in the *Study Guide*. Two prepared midterms and two comprehensive final examinations, totaling 300 questions, are also available in the *Test Bank*.

RANDOM HOUSE TESTMAKER The entire *Test Bank* is available on IBM-PC, Apple II, and Macintosh microcomputers. This program enables instructors to view, edit, and test questions to create exams. Scrambled versions of the same test can be created. Questions can be selected based on level of difficulty or learning objective.

CUSTOMIZED TEST Instructors may have tests custom prepared by the publisher by calling the publisher's special test service. Masters prepared from the *Test Bank* will be mailed out within 72 hours.

Overhead Transparencies

Over 100 of the key tables and graphs in the text have been reproduced as overhead masters. These are made available to users by the publisher.

A COMPLETE TEACHING PACKAGE

We have tried to assemble a complete teaching package for classroom use. In the process we have introduced several unique text features, including the chapters concerned with economic problems; the liberal use of news stories and other supplementary materials; the running glossary; and an

explicit, simultaneous introduction to both theory and institutions. In the *Study Guide* we have introduced the “Common Errors” section and a greater emphasis on learning basic definitions. The *Instructor’s Resource Manual* features the “Take a Stand” section, as well as “News Updates.” We have tried to present all of the material in a lively manner that stimulates student interest.

Have we succeeded in producing a new and effective teaching package? We hope so. The real test will be administered by students who use this text. Success will be measured in terms of increased student interest in and understanding of the economy today.

ACKNOWLEDGMENTS

Especially noteworthy in this edition is the assistance of Roger Frantz, of San Diego State University, who contributed most of the ideas and much of the material for the new chapter (11) on productivity of the firm. Professor Frantz has expertly bridged the span between economic cost concepts and the tools of business management.

Other contributors have offered their careful reviews and advice on this and earlier editions. Those whom I would like to thank for their labors on this edition include:

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