



PRICE THEORY AND APPLICATIONS

Second Edition

B. Peter Pashigian

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PRICE THEORY AND APPLICATIONS

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P R E F A C E

The second edition of *Price Theory and Applications* continues the objectives and expectations of the first edition by clearly presenting the essentials of microeconomic theory and, equally important, applying the theory to consumer and firm behavior.

As the book's title suggests, my underlying conviction is that microeconomics can best be taught through an artful blend of theory and application. One without the other represents a failing. It is an unfortunate fact of life that many students who take intermediate microeconomics courses will never take another economics course. Only a minority of students take upper-level courses where they have an opportunity to apply the theory. In most business schools microeconomics is a required course but students seldom go on to apply the theory in advanced work. Given this fleeting rendezvous with microeconomics, I believe the study of microeconomics can be made worthwhile and even exciting by showing how the theory can be applied.

Each chapter in the second edition of *Price Theory and Applications* includes interesting and serious real-world applications, not only hypothetical examples. Former students have praised the applications and I believe readers of the second edition will too. Numerous reviewers of the second edition have been struck by the successful integration of the theory with unique and relevant applications. As one reviewer wrote, "Pashigian's greatest strengths are the breadth and relevance of his applications." This is a source of personal satisfaction since my objective was to write a rigorous book that showed how theory can be applied. I wrote this textbook because I thought the existing books could be improved upon. Some were books in logic that left students wondering why they had learned the theory. Others skimmed on theory and presented applications that at times were either contrived or only distantly related to the theory. I have made a conscientious effort to motivate students' interest in theory by using incisive real-world applications in every chapter that lend an empirical dimension to the book.

The central premise of the book is that much behavior can be explained as a rational response to economic incentives. Because the theory has general applicability, the analyses in *Price Theory and Applications* deal with issues that are not specific to one economy but are universal to all modern economies. For instance, incentives matter even for a staple like water, which is essential for life. Even for water, when its price rises, consumers use less of it by modifying their behavior in numerous little ways, such as watering their lawns less frequently, taking shorter showers, and using mulch to preserve moisture for their plants. When the price of cotton rises because of a disease that has diminished the Asian cotton crop, producers throughout the world respond to the higher prices by

shifting into cotton production and out of production of other crops. Obvious or subtle responses like these to changing economic incentives occur daily in local economies and throughout the world economy. Understanding the role of incentives is the most important lesson that students can gain from their study of microeconomics.

Distinctive Features of the Book

To find fresh and interesting applications, I look more to private sector behavior and less to government behavior, which is the more conventional practice in many microeconomics textbooks. I believe the favorable response to the book is due in part because I did not use the cut-and-dried applications involving the government. Other applications prepare students for the end-of-chapter Review Questions and Exercises, which are another especially valuable feature of the book that test the students' understanding of the theory by asking them to apply the theory in new and different situations. Applying microeconomic theory to new situations is exactly what many students will be doing the rest of their working lives.

Core Chapters 1, 2, part of 3, and 5 through 10 cover consumer behavior, the theory of the firm, and price formation under different structures. A differentiating feature of this book is its systematic examination of several topics that are either not treated or treated superficially elsewhere. Numerous reviewers have mentioned that a strength of the book is Part V, dealing with pricing practices and policies. Chapters 12 through 15 in Part V develop several models that help explain firms' price policies. Chapter 12, "Price Discrimination," presents an in-depth examination of the different forms of price discrimination. Unlike most books where the free rider problem is discussed but only in the context of the provision of public goods, Chapter 13, "The Free Rider Problem and Pricing," shows how frequently private markets face free rider problems and how firms use prices and other methods to circumvent these problems. Students find this topic fascinating and consistently rank the chapter among the most interesting, and I urge instructors to include part or all of the chapter in their course outlines. Chapter 14, "Market Behavior with Asymmetric Information," discusses how firms acquire a reputation for honesty and how private markets adapt to situations where asymmetric information exists. Chapter 15, "Pricing under Uncertainty," introduces the topic of uncertainty by showing how the theory of pricing under uncertainty explains seasonal variation in pricing and the growing frequency of sales.

Other chapters also treat significant subjects that are often ignored. The cost of time receives comprehensive treatment in Chapter 4, "The Cost of Time and the Theory of Consumer Behavior." With more women in the work force and with women's earnings rising faster than men's, time plays a more and more influential role in explaining consumer behavior and should receive greater recognition in microeconomics texts. Another important but ignored topic is the governance of the firm. After the decade of the 80s when many hostile takeovers and mergers occurred, can a modern textbook ignore the topic of firm governance and the role of product and capital markets in monitoring the policies of management? Much has been learned about the role of the capital market in monitoring management

performance in the last 15 years and this topic receives full treatment in Chapter 11, “Monitoring the Corporation: Corporate Governance.”

Changes for the Second Edition

Changes have been made to virtually all chapters. Care has been taken to rewrite theory sections and Applications when students’ or reviewers’ comments have asked for greater clarity. We have also clarified and simplified the Figures so they can be more easily understood. In many chapters fresh and up-to-date Applications replace older ones. New Review Questions and Exercises have been added in the second edition, and in response to suggestions by adopters, some easier exercises have been added. More difficult exercises are now marked with asterisks (*).

In response to suggestions by users, the second edition of *Price Theory and Applications* presents an intuitive explanation of consumer surplus in the body of Chapter 3 and presents the “correct” formal derivation of consumer surplus using indifference curves at the end of Chapter 3 in the Appendix. Chapter 8 includes an interesting new application of when a firm should introduce a new cost-reducing innovation and retire an older technology by looking at the retirement of the Boeing 707 after the price of jet fuel increased. In Chapter 8, for instructors who like to use consumer and producer surplus in a partial equilibrium welfare analysis, I have included a section on the effect of taxes, trade limitations, and market restrictions on total surplus. The gains from trade are also illustrated in Chapter 8 in a new Application entitled “Banana Wars: Total Surplus and the Gains from Trade,” which examines the impact on consumer and producer surplus in the United States and in Europe after the European Union’s imposed quotas on banana imports from Latin America. Partial equilibrium welfare analysis reappears in Chapter 9 in a new Application where readers consider the consequences of a merger between two hospitals that may reduce the cost of supplying health care but may also create a monopoly.

The concept of strategic interaction is introduced at the beginning of Chapter 10, “Oligopoly and Monopolistic Competition.” In response to adopters’ requests, the second edition gives a more extended analysis of repeated games, sequential games, and the theory of monopolistic competition. I have filled out the discussion of price discrimination in Chapter 12 by including a section on when bundling is profitable. Besides considering a specific version of the lemons problem, a more general model of the lemons problem is presented in Chapter 14, which now includes an extended discussion of the moral hazard problem and an analysis of when a monopolist will acquire a reputation for reliability and honesty. Among the new additions to Chapter 17, “Wage Determination in Labor Markets,” is a section on the effects of the minimum wage and Applications that deal with substitution and scale effects in the airline industry and the topic of whether the wage premium for a college education has peaked.

These and other changes will make the second edition of *Price Theory and Applications* even more interesting and educational for instructors and students alike and will contribute to an increased understanding of how the price system functions.

Alternative Course Designs

Deciding which topics to include in a course is always a challenge, so some guidance may be helpful. The modular form of the book gives instructors considerable flexibility with regard to both content and level of difficulty. For a quarter course offered in an economics department an instructor may include Chapters 1–3, 5–10, and parts of Chapters 17–19. For a quarter course offered in a business school an instructor may include Chapters 1–2, the section of Chapter 3 on consumer surplus, and Chapters 4 and 6–10, and then select sections from Chapters 11–15. Instructors in business schools often do not include production theory and they can confidently skip to Chapter 6 where the development of the cost functions of the firm is independently derived. For a semester course offered by a department an instructor may include Chapters 1–10, all or part of 12, and 17–19, and then select among Chapters 4, 11, and 13–16. For a semester course a business school instructor may include Chapters 1–4, and 6–13 and supplement these chapters with parts of Chapters 14–15, 17, and 19.

Alternative Levels of Rigor

Price Theory and Applications was written and organized to give the instructor considerable flexibility in deciding whether to include or exclude, as appropriate, the sections denoted by asterisks (*), which cover more difficult material. There is also flexibility in the use of mathematics with most of the calculus placed in footnotes or in appendixes. Special care was taken to keep the exposition clear without sacrificing rigor. The second edition of *Price Theory and Applications* is appropriate for students with diverse backgrounds and interests.

The Teaching and Learning Package

Study Guide Professor Thomas Carroll of the University of Nevada at Las Vegas has prepared a detailed and user-friendly Study Guide that summarizes the major points in each chapter and gives the student ample opportunity to work multiple-choice and short answer problems.

Test Bank I was especially pleased when Charles Upton, now at Kent State University, agreed to do the Test Bank, since we saw eye-to-eye as to how a microeconomics course should be taught when Charles was a colleague at the University of Chicago. The Test Bank includes a variety of new short answer and story problems that test a student's understanding of each chapter's fundamentals.

Instructor's Resource Manual The Instructor's Resource Manual is once again prepared by Richard Peck. It follows the lead of the textbook in the application of economic concepts to real-world problems. Shane Greenstein at the University of Illinois contributed questions, some of which are included in the text and others in the Instructor's Resource Manual.

The Test Bank is available in a computerized format and an electronic version of the Instructor's Resource Manual is available to adopters by special request to your local Irwin-McGraw-Hill sales representative.

Acknowledgments

The second edition has benefited from the contributions of many. First, many thanks to those adopters of the first edition who suggested changes for the second edition. I have used this book in two different courses that I teach in the Graduate School of Business at the University of Chicago and extend my thanks to my former students who completed questionnaires, offered their opinions, and identified sections requiring greater clarity. The second edition is better because of their efforts. I want to particularly praise Jeanne Mey Sun who diligently read each chapter, correcting errors and suggesting rephrasing. I want to single out Lucille Sutton, Economics Editor at McGraw-Hill, who supervised the second edition while managing it from one stage to another. Accolades go to Stephanie Cappiello, Assistant Editor, who performed admirably while finding reviewers and tending to seemingly endless details. A word of appreciation is extended to Beth Cigler, Senior Project Manager, who guided the book through the production process.

Many economists across the country offered suggestions for the second edition after reading chapters in the first edition. Others read revised chapters for the second edition and made further suggestions. I am indebted to them for sharing their suggestions, praise, and criticism. They include **Jack Adams**, University of Arkansas at Little Rock; **James D. Adams**, University of Florida; **Michael Balch**, The University of Iowa; **David S. Ball**, North Carolina State University; **Howard Beales**, George Washington University; **Gautam Bhattacharya**, University of Kansas; **Michael R. Butler**, Texas Christian University; **David A. Butz**, University of Michigan; **Richard R. Cornwall**, Middlebury College; **Carl E. Enomoto**, New Mexico State University; **Paul G. Farnham**, Georgia State University; **Raymond J. Farrow**, Seattle University; **Robert G. Hansen**, Dartmouth College; **Donald B. Hausch**, University of Wisconsin–Madison; **Joseph W. Hunt**, Shippensburg University; **Thomas R. Ireland**, University of Missouri–St. Louis; **David R. Kammerschen**, University of Georgia; **Daniel Leonard**, Flinders University of South Australia; **Karen Lombard**, University of Miami; **Richard Manning**, Brigham Young University; **Thomas E. Merz**, Michigan Technological University; **Paul F. Okello**, The University of Texas at Arlington; **Sol Shallt**, University of Wisconsin–Milwaukee; **Paula Tkac**, University of Notre Dame; **Charles W. Upton**, Kent State University; **Juuso Valimaki**, Northwestern University; and **Chiou-nan Yeh**, Alabama State University.

Finally, a special word of gratitude to my wife Rose, who exhibited such patience once again while sharing her husband with the second edition of *Price Theory and Applications*.

B. Peter Pashigian

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ABOUT THE AUTHOR

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C O N T E N T S I N B R I E F

PART I	
Introduction: Supply and Demand	1
CHAPTER 1 Pricing and the Demand and Supply Model	3
PART II	
Consumer Behavior	45
CHAPTER 2 Consumer Behavior and Market Demand	47
CHAPTER 3 Extending the Theory of Consumer Behavior	93
CHAPTER 4 The Cost of Time and the Theory of Consumer Behavior	142
PART III	
The Firm: Its Technology and Costs	169
CHAPTER 5 The Production Function and Costs of the Firm	171
CHAPTER 6 The Cost Functions of the Firm	217
PART IV	
Firm and Market Behavior	253
CHAPTER 7 The Supply Functions of a Competitive Firm	255
CHAPTER 8 Price Determination in a Competitive Industry	277
CHAPTER 9 Monopoly	327
CHAPTER 10 Oligopoly and Monopolistic Competition	367
CHAPTER 11 Monitoring the Corporation: Corporate Governance	416
PART V	
Pricing: Practices and Policies	443
CHAPTER 12 Price Discrimination	445
CHAPTER 13 The Free Rider Problem and Pricing	487
CHAPTER 14 Market Behavior with Asymmetric Information	517
CHAPTER 15 Pricing under Uncertainty	556
PART VI	
Intertemporal Equilibrium and Factor Markets	581
CHAPTER 16 Consumer and Supplier Behavior over Time	583
CHAPTER 17 Wage Determination in Labor Markets	624
PART VII	
Markets and Economic Efficiency	665
CHAPTER 18 Economic Efficiency and General Equilibrium	667
CHAPTER 19 Externalities and Public Goods	699
Suggested Answers to Selected Exercises and Problem Sets	724
Index	751
	xi

C O N T E N T S

PART I INTRODUCTION: SUPPLY AND DEMAND **1**

CHAPTER 1

Pricing and the Demand and Supply Model	3
1-1 The Meaning of Demand and Supply	5
1-2 The Market Demand Function	5
Movement along a Demand Function • Application 1-1: The Rising Price of Wood and the Demand for Wood • Shifts in the Demand Function	
1-3 The Market Supply Function	10
Movements along the Supply Function • Shifts in the Supply Function	
1-4 Market Equilibrium	13
The Everyday Meaning of Demand and Supply • Problems with the Analysis	
1-5 Changes in Equilibrium: Shifts in Market Demand and Market Supply Functions	17
Shifts in Demand • Application 1-2: Demand and Supply on Valentine's Day • An Explanation of Shortages and Surpluses • Application 1-3: Cotton Is King Again, but How Long the Reign? • Application 1-4: Should Your Company Support a Lobbying Effort to Reduce the Price of an Input?	
1-6 The Price Elasticity of Demand and Supply	27
Price Elasticity of Demand • Point Price Elasticity of Demand • Arc Price Elasticity of Demand • Application 1-5: The Price Elasticity of Demand for First Class Mail • Determinants of the Price Elasticity of Demand • Price Elasticity of Supply	
Summary	38
Key Terms	38
Review Questions	39
Exercises	40
Problem Set: Estimating the Price Elasticity of Demand	42

PART II CONSUMER BEHAVIOR **45**

CHAPTER 2

Consumer Behavior and Market Demand	47
2-1 Building the Consumer Behavior Model	48
Assumptions about Consumer Behavior	
2-2 Describing Consumer Preferences	49
Indifference Curves • The Marginal Rate of Substitution • The Indifference Map of a Consumer • Assigning Numbers to Indifference Curves	
2-3 Properties of Indifference Curves	57
2-4 Budget Constraint	58
Affordable Market Baskets • Shifts in the Budget Constraint	
2-5 The Consumer's Consumption Decision	64
Finding the Market Basket That Maximizes Utility and Satisfies the Budget Constraint • Specialization of Consumption • Application 2-1: Pricing to Break into an Established Market	

2-6	Introducing a Composite Good into the Consumer Behavior Model	70
2-7	The Market Demand Function	71
	The Consumer's Demand Function • Application 2-2: Measuring Brand Loyalty by Relative Frequency of Purchase • Market Demand: Adding Up the Individual Demand Functions • Application 2-3: Why Are Americans Eating More Poultry and Less Red Meat?	
2-8	Substitutes and Complements	78
2-9	Applying the Consumer Behavior Model	81
	Application 2-4: Earmarked versus General-Purpose Grants	
	Summary	84
	Key Terms	85
	Review Questions	85
	Exercises	86
	Problem Set: Will a Challenge Grant Increase Alumni Contributions?	89
 CHAPTER 3		
	Extending the Theory of Consumer Behavior	93
3-1	The Shape of the Consumer's Demand Function	94
	Measuring the Income Effect • Income Elasticity of Demand • Measuring the Substitution Effect • Combining the Two Effects • The Effect of a Price Change on the Quantity Demanded • Application 3-1: Subsidizing Day Care • Application 3-2: How Different Is Water? • The Slope of the Demand Function • The Size of Each Effect • Observing the Effect of Each Determinant	
3-2	Consumer Surplus	118
	Marginal Value • Using the Consumer Surplus Concept	
*3-3	Uncertainty and Consumer Decision Making	123
	The Expected Income Hypothesis • The Expected Utility Hypothesis • Risk Aversion and Risk Taking • Buying Insurance • Application 3-3: Why Is Earthquake Insurance a Slow Seller in California?	
	Summary	135
	Key Terms	135
	Review Questions	135
	Exercises	137
	*Appendix: Deriving Marginal Values	139
 CHAPTER 4		
	The Cost of Time and the Theory of Consumer Behavior	142
4-1	Affordable Market Baskets	143
	The Limits of Time • The Budget Constraint • Deriving the Full Price Budget Constraint • Full Prices • Application 4-1: Walgreens Offers Convenience • Using the Full Price Budget Constraint to Find Affordable Market Baskets • Shifts in the Full Price Budget Constraint	
4-2	The Revised Consumer Behavior Model	152
	Choosing a Market Basket • The Effects of a Change in Nonwage Income and the Wage Rate • Application 4-2: Which Consumers Purchase Gasoline at Below the Market Price?	
4-3	Finding the Lowest Full Price	157
	Dependence of the Full Price on the Market Price • Application 4-3: How Much More Will Some Consumers Pay to Save Time?	
4-4	The Rising Cost of Women's Time	163
	The Increasing Number of Working Women • Differences in the Cost of Time for Females and Males • The Increase in Female Earnings Relative to Male Earnings	
	Summary	166
	Key Terms	167

Review Questions	167
Exercises	167

PART III THE FIRM: ITS TECHNOLOGY AND COSTS **169**

CHAPTER 5

The Production Function and Costs of the Firm	171
5-1 The Production Function	172
5-2 Changing Factors of Production in the Short and Long Runs	174
5-3 The Short-Run Production Function	175
The Total, Average, and Marginal Product of Labor • Application 5-1: Distinguishing between Marginal and Average Productivity	
5-4 The Long-Run Production Function	182
Substitution among Factors • The Marginal Rate of Technical Substitution • Returns to Scale • Returns to Scale and the Cobb-Douglas Production Function • Application 5-2: Substitution and Returns to Scale for a Pipeline Production Function • The Marginal Rate of Technical Substitution and the Marginal Product of Both Factors	
5-5 The Isocost Function	191
5-6 Minimizing the Total Cost of Producing a Given Quantity	193
5-7 The Long- and Short-Run Total Cost Functions	196
The Long-Run Total Cost Function • Returns to Scale and the Shape of the Long-Run Average Cost Function • Application 5-3: The Long-Run Average Cost Function of a Pipeline • The Short-Run Total Cost Function	
5-8 Shifts in the Long-Run Total Cost Function	204
A Change in the Price of a Factor • Technological Change • Application 5-4: Substituting Aluminum for Steel in Autos	
5-9 The Production Function and Learning-by-Doing	208
Application 5-5: Learning-by-Doing in the Semiconductor Industry • Application 5-6: Learning-by-Doing at the Indianapolis 500	
Summary	212
Key Terms	212
Review Questions	213
Exercises	214

CHAPTER 6

The Cost Functions of the Firm	217
6-1 Defining Costs	218
6-2 The Short and Long Runs	219
6-3 The Short-Run Cost Functions of the Firm	220
Graphing the Short-Run Cost Functions • The Marginal and Average Cost Functions • The Area under the Marginal Cost Function	
6-4 Identifying the Relevant Costs When Solving Short-Run Cost Problems	228
Application 6-1: How to Schedule Production between a New Plant and an Old Plant • Application 6-2: Why “Never Give Up” Is Not Always the Best Advice • Application 6-3: Inefficient or Efficient Environmental Regulation • Application 6-4: Why Are Fewer Sellers of Used Homes Using Brokers?	
6-5 Deriving the Long-Run Average Cost Function from the Short-Run Average Cost Functions	238
The Long-Run Average Cost Function with a Limited Choice of Plants • The Long-Run Average Cost Function with a Continuum of Plant Sizes	

6-6	The Number of Firms and the Long-Run Cost Function	242
	Diseconomies of Scale and Industries with Many Firms • Economies of Scale and Industries with Few Firms • Application 6-5: The Emergence of the Standard Oil Company • Application 6-6: Size of Firm and Technological Change in the Steel Industry	
	Summary	248
	Key Terms	248
	Review Questions	248
	Exercises	249

PART IV FIRM AND MARKET BEHAVIOR **253**

CHAPTER 7

	The Supply Functions of a Competitive Firm	255
7-1	The Competitive Firm	255
	The Price-Taking Assumption • The Price Elasticity of Demand of a Competitive Firm • Application 7-1: The Price Elasticity of Demand of Firms in Eastern Europe and Russia	
7-2	The Short-Run Supply Function of a Competitive Firm	261
	Finding an Output That Maximizes Total Short-Run Profits • The Short-Run Supply Function of a Competitive Firm • Application 7-2: Short-Run Costs, Break-Even Analysis, and Profit-Maximizing Behavior • Application 7-3: When to Lay Up an Oil Tanker	
7-3	The Long-Run Supply Function of a Competitive Firm	269
	Finding an Output That Maximizes Long-Run Profits • The Long-Run Supply Function of a Competitive Firm	
	Summary	273
	Key Terms	273
	Review Questions	273
	Exercises	274
	Problem Set: Should Your Company Honor a Contract?	275

CHAPTER 8

	Price Determination in a Competitive Industry	277
8-1	Requirements for Long- and Short-Run Industry Equilibria	278
	Long-Run Industry Equilibrium • Short-Run Industry Equilibrium • Typical Competitive Industries	
8-2	Price Determination in a Constant-Cost Industry	279
	Two Assumptions of a Constant-Cost Industry • The Long-Run Industry Supply Function in a Constant-Cost Industry • Long-Run Industry Equilibrium in a Constant-Cost Industry	
8-3	Moving from One Long-Run Equilibrium to Another	283
	The Short-Run Industry Supply Function and Equilibrium Price • High Prices Cure High Prices • The Role of Profits • Application 8-1: Helping the Victims of Hurricane Andrew	
8-4	Price Determination in an Increasing-Cost Industry	291
	A Rising Factor Price When Industry Output Expands • Economic Rent or Producer Surplus • Differences in Firm Costs Due to Differences in Managerial Ability • Long-Run Industry Equilibrium When Managerial Ability Differs	
*8-5	Adoption of a Cost-Reducing Innovation	299
	Application 8-2: Higher Jet Fuel Price Downs the Boeing 707 • Application 8-3: Regularities in the Evolution of Industries	

8-6	Raising the Costs for New Entrants	307
	How Licensing Changes the Shape of the Long-Run Industry Supply Function • Application 8-4: The Value of a License	
8-7	The Effect of Taxes, Trade Limitations, and Market Restrictions on Total Surplus	310
	Imposing a Per Unit Tax on a Competitive Firm • Long-Run Effects of a Per Unit Tax • Banana Wars: Total Surplus and the Gains from Trade • The Effect of a Per Unit Tax on Consumer and Producer Surplus	
	Summary	321
	Key Terms	322
	Review Questions	322
	Exercises	323

CHAPTER 9

	Monopoly	327
9-1	Assumptions of the Pure Monopoly Model	328
9-2	The Monopolist as a Price Maker	329
	The Demand Function of a Monopolist • The Total and Marginal Revenue Functions • Measuring the Change in Revenue by the Area under the Marginal Revenue Function	
9-3	The Theory of Monopoly Pricing	337
	Application 9-1: Are Firms in the Cigarette and Oil Industries Monopolists? • Application 9-2: Privatizing a Near Monopoly in the Czech Republic • *Application 9-3: Using a Quota to Create a Partial Monopolist	
9-4	Adjusting from One Long-Run Equilibrium to Another	347
*9-5	Adoption of a Cost-Reducing Innovation	347
9-6	Competing to Be a Monopolist	351
	Application 9-4: Alternative Methods of Selling a Monopoly	
9-7	The Tyranny of Durability	352
	Actions the Monopolist Can Take to Reassure Buyers • Application 9-5: Disney Limits the Sales of <i>Fantasia</i> to 50 Days	
9-8	Taxing a Monopolist	358
9-9	The Social Objection to Monopoly	360
	Application 9-6: Will a Merger of Two Hospitals Decrease Total Surplus?	
	Summary	362
	Key Terms	363
	Review Questions	364
	Exercises	364

CHAPTER 10

	Oligopoly and Monopolistic Competition	367
10-1	Cooperation among Price-Taking Firms: Cartel Behavior	368
	Application 10-1: Trouble in the Orange Cartel	
10-2	Price and Output with Oligopoly	371
	Cooperative Behavior and the Incentive to Cheat	
10-3	Models of Noncooperative Behavior	376
	The Cournot Model • The Reaction or Best Response Function of Each Cournot Rival • The Nash Equilibrium • Application 10-2: More Suppliers of Fine Caviar • The Cournot Model with n Competitors • The Bertrand Model • Application 10-3: Encouraging Competition among Suppliers	
10-4	The Effect of the Number of Rivals on Price	388
	Application 10-4: Retail Tire Prices • Application 10-5: Auction Markets	

10-5	Facilitating and Preventing Collusion	391
	Meeting Competition • Application 10-6: Detecting the Effects of Facilitating Practices • Preventing Collusion	
10-6	A Case Study: The Electrical Manufacturers' Conspiracy	394
	Collusion and Cheating • Product and Industry Characteristics and Successful Collusion • The Cost of Detecting Price Chiseling	
10-7	Game Theory and Noncooperative Strategies	398
	Dominant Strategies • A Dominant Strategy for Only One Firm • Application 10-7: Which Brands Enter Late and Which Enter Early? • Nash Equilibria • Repeated Games • Sequential Games • Application 10-8: Credible Commitment for <i>Independence Day</i>	
10-8	Monopolistic Competition	409
	Summary	411
	Key Terms	411
	Review Questions	412
	Exercises	412
	Appendix: How the Number of Rivals Affects Firm Output and Price in the Cournot Model	414
 CHAPTER 11		
	Monitoring the Corporation: Corporate Governance	416
11-1	External Monitors: Product and Capital Markets	417
	Application 11-1: The Effect of a Change in Management on Operations	
11-2	The Free Rider Problem and the Tender Offer	419
11-3	Internal Monitors of Management	422
	Expense Preference • Ex Post Settling Up	
11-4	The Principal-Agent Relationship and Ownership Structure	425
11-5	Expense Preference under a Profit Constraint	429
	The Profit Constraint • Deregulation and Import Competition	
11-6	The Unregulated Firm and Expense Preference	434
	Application 11-2: Cummins Engine Company	
11-7	How the Market for Corporate Control Functions	435
	The Effectiveness of Internal Monitors • The Effectiveness of External Monitors • Evidence about Takeovers • The Effect of Takeovers on the Stock Performance of Targets and Acquirers	
	Summary	441
	Key Terms	441
	Review Questions	441
	Exercises	442

PART V PRICING: PRACTICES AND POLICIES **443**

CHAPTER 12

	Price Discrimination	445
12-1	Revenue Enhancement: The Goal of Price Discrimination	446
12-2	First-Degree (Perfect) Price Discrimination	448
12-3	Second-Degree Price Discrimination	449
12-4	Third-Degree Price Discrimination	452
	Methods of Grouping Consumers: Examples • Finding the Optimal Pricing Policy for a Given Total Quantity • Price Elasticity and Pricing Strategy • Application 12-1: Universities Are Learning More about Differences in the Price Elasticity of Demand of their Students • Reconsideration of the Examples •	

Finding the Optimum Output to Produce and Prices to Charge • Application 12-2: Should a Firm Expand into the European Market? • Preventing Arbitrage • Application 12-3: Pricing a Renault in Belgium and in England • The Difference between Second- and Third-Degree Price Discrimination	
12-5 Bundling	471
12-6 Two-Part Tariffs	474
Setting the Fixed Fee and Per Unit Price for Identical Consumers • Setting the Fixed Fee and Per Unit Price for Different Types of Consumers • Using Two-Part Tariffs to Price Consumer Capital Goods • Application 12-4: Why Did IBM and Xerox Lease Rather Than Sell Their Machines?	
Summary	480
Key Terms	481
Review Questions	481
Exercises	481
 CHAPTER 13	
The Free Rider Problem and Pricing	487
13-1 Free Rider Problems in Different Markets	488
Application 13-1: IBM Sues a Former Employee	
13-2 Why Are Manufacturers Interested in the Retail Price?	492
Case 1: GM's Restriction on Dealer Sales • Case 2: IBM and Apple Restrictions on Dealers • Case 3: Discounting Prince Tennis Rackets	
13-3 Benefiting from Retail Price Competition	494
Allowing Free Entry of Retailers • Deriving the Inverse Wholesale Demand Function • Maximizing the Profits of the Manufacturer	
13-4 The Special Service Theory and the Free Rider Problem in Retailing	499
The Special Service Theory • Resale Price Maintenance and the Special Service Theory • Applying the Theory to Explain Behavior • The Role of Each Assumption • Why Does Free-Riding Appear in Retailing? • Dealing with the Free Rider Problem without Using a Minimum Suggested Retail Price • The Objection to RPM: Facilitating a Cartel	
13-5 Free-Riding with Quality Certification	507
Application 13-2: Testing New Toys at Small Toy Stores • Application 13-3: Toys "R" Us Wants Toy Manufacturers to Sell to It Exclusively	
13-6 Free Rider Problems between Manufacturers	510
Application 13-4: Ben and Jerry versus Goliath	
Summary	512
Key Terms	512
Review Questions	513
Exercises	513
Problem Set: A Young Designer and the Free Rider Problem	515
 CHAPTER 14	
Market Behavior with Asymmetric Information	517
14-1 Consequences of Asymmetric Information	518
Example: Health Insurance • Example: Automobile Insurance • Example: Borrowing in the Credit Market	
14-2 Asymmetric Information and Adverse Selection	520
A Lemons Model • Equilibrium Prices and Quantities with Complete Information • Equilibrium Price and Quantity with Asymmetric Information • *A More General Treatment of the Lemons Problem • Overcoming Asymmetric Information • Identifying Markets for Lemons • Application 14-1: The Free Agency Market in Professional Baseball • Application 14-2: The Used Pickup Truck Market	