

*Sixth  
Edition*

# ***MICROECONOMICS***

## ***Private and Public Choice***

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***James D. Gwartney / Richard L. Stroup***





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## **Private and Public Choice**

### **Sixth Edition**

***James D. Gwartney***

*Florida State University*

***Richard L. Stroup***

*Montana State University*

*with the assistance of*

***A. H. Studenmund***

*Occidental College*

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# ***Preface***

We live in a world of dynamic change. During the last few years, the Berlin wall has fallen; democratic governments have emerged in Eastern Europe and Latin America; and global competition has increased in intensity. Economics helps us better understand both the underlying forces and future implications of these changes. Perhaps more than any other science, economics is about people. It enhances our understanding of today's crucial issues. Why do some people prosper, while others live on the edge of starvation? Will the adoption of democratic political institutions improve economic conditions? Is there a danger that we are about to run out of key economic resources? Is economic activity destroying the environment of planet Earth and, if so, what can be done about it? As we proceed, we will use the tools of economics to address these and many other important issues that affect our lives.

## ***SIXTH EDITION***

As in previous editions, our approach emphasizes the importance of the economic way of thinking. We want to stimulate students, challenge their reasoning ability, and teach them to *think* like economists. Examples are used freely to illustrate the power and relevance of economic analysis. Real-world data are employed to test the implications of economic theory. We think this approach will enliven the study of economics for both the student and the teacher.

While the organization of this text is basically the same as for the previous edition, almost every chapter has been thoroughly revised. Several new features have been incorporated. This edition reflects the global relevance of economic analysis. We now live in a shrinking world that is characterized by dynamic change. Pushed along by changes in technology, communications, and transportation, more and more of our economic goods are produced in one country and sold in another. The economies of countries in Latin America, Eastern Europe, and even the Soviet Union are in the midst of enormous change. Europe is moving toward political and economic unification. North America appears to be moving toward a common market. Basic economic analysis enhances our understanding of these forces and helps clarify their impact on our lives.

## ***CHANGES IN THE CORE MICROECONOMICS***

Our coverage of core microeconomics stresses the ability of a limited number of basic principles (for example, opportunity costs, gains from specialization and trade, competition and adjustments to relative price changes) to enhance our

understanding of real world events. Theoretical analysis is always supplemented with applications which illustrate the relevance of the theory. The following brief list indicates the major areas of substantial change.

- The discussion of rivalrous behavior and business strategy is expanded and the models of monopolistic competition and oligopoly are more fully used to explain these aspects of business competition (Chapter 10).
- The coverage of price discrimination is expanded, and its use as a competitive weapon is more fully explored in this edition (Chapter 9).
- The changing role of labor unions and the impact of product market competition and mobility of firms on the economic power of organized labor are analyzed in more detail in this edition (Chapter 15).
- Recent changes in income inequality and the economic factors contributing to these changes are analyzed in more detail.
- The coverage of environmental economics is expanded and integrated more fully into our analysis of resource economics (Chapter 17).
- A new feature on educational vouchers is integrated into our analysis of public sector economics (Chapter 19).
- The coverage of the “new development economics” which stresses the importance of gains from trade, monetary (price) stability, security of property rights, and an efficient capital market is expanded.
- The chapter on comparative economic systems outlines the latest economic developments in the Soviet Union, considers their importance, and analyzes the future of the Soviet economy.

## ***DISTINGUISHING FEATURES OF OUR APPROACH***

As we stated in the first edition of this text, our primary goal is to challenge students to think like economists. The following points are of specific interest in this regard:

1. *Economic Principles Are Presented in a Highly Readable Fashion.* Difficult language and terminology can often hinder successful learning, particularly of economic concepts. Without sacrificing accuracy, we have sought to employ simple language. Simplicity, however, has not been substituted for depth. Rather, our aim is to highlight the power and accessibility of economic concepts. Where complex ideas are essential to our analysis, they are developed fully. We believe that the economics required for the 1990s can be comprehensible to the student as well as challenging and applicable to the real world.
2. *Economic Reasoning and Its Applications Are Emphasized.* Although models, theories, and exercises are important, they are only tools with which to develop the economic way of thinking. We have avoided abstractions and mechanical exercises that obscure basic concepts. On the other hand, we have integrated applications and real world data in an effort to make the basic concepts come alive to the reader.
3. *Economic Tools Are Applied to Both the Market and the Political Process.* Most textbooks tell students how an *ideal* market economy would operate,

how real-world markets differ from the hypothetical ideal, and how ideal public policy can correct the shortcomings of the market. In addition to discussing these three basic issues, we analyze what real-world public policy is *likely to do*. Building on recent developments in the area of public choice, we apply the tools of economics to the political process as well as to market allocation. We think this approach emphasizes both the power and relevance of economics.

4. *The Role of the Individual Decision-Maker Is Stressed.* Students often feel that economists exclude human beings from the economic process. In most economics textbooks, business decision-makers are depicted as having perfect knowledge of demand and cost. Like computers, they always arrive at the maximum-profit solution. Likewise, government planners are often depicted as omniscient mechanics who always do the right thing. Decision-making is treated as a mechanical exercise, removed from the real world. We reject this approach. Throughout this book, we stress the importance of information, uncertainty, trial-and-error decision-making, expectations, and other factors that influence real-world choices. Economics is more than a set of guidelines. If students are to be convinced of its applicability, these dynamic factors that influence and motivate human beings must be integrated into the analysis.

## ORGANIZATIONAL FEATURES

We have employed several organizational features designed to make the presentation more understandable and interesting.

1. *Myths of Economics* In a series of boxed articles, commonly held fallacies of economic reasoning are dispelled. Each myth is followed by a concise explanation of why it is incorrect and each one is presented within a chapter containing closely related material.
2. *Applications in Economics* These boxed features apply economic theory to real-world issues and controversies. They add breadth on topics of special interest and illustrate the relevance of basic principles to the world in which we live.
3. *Measures of Economic Activity* Measurement is an important element of economics. These features explain how important economic indicators such as the Consumer Price Index, unemployment rate, and index of leading indicators are assembled.
4. *Outstanding Economists* These brief profiles stress the contributions of several economists, both current and historical, whose work has been important in the development of the field. This series is designed both to enhance the student's appreciation of economic history and to provide depth on the contributions of several present-day economists.
5. *Chapter Focus Questions and Closing Summaries* Each chapter begins with several questions that summarize the focus of the chapter. A summary, which provides the student with a concise statement of the material (chapter learning objectives), appears at the end of each chapter. Reviewing the focus questions and chapter summaries will help the student better understand the material and integrate it into the broader economic picture.

6. **Key Terms** The terminology of economics is often confusing to introductory students. Key terms are introduced in the text in color type; simultaneously, each term is defined in the margin opposite the first reference to the term. A glossary containing the key terms also appears at the end of the book.
7. **Critical Analysis Questions.** Each chapter concludes with a set of discussion questions designed to test the student's ability to analyze an economic problem and to apply economic theory to real-world events. Appendix C at the end of the text contains suggested answers for approximately half of the critical analysis questions. We think these answers, illustrating the power of economics, will interest students and will help them develop the economic way of thinking.

## SUPPLEMENTARY MATERIALS

A complete set of support materials accompanies this textbook and includes:

**Coursebook.** We call the student handbook accompanying the textbook a *Coursebook*, since it is more than a study guide. Of course, it contains numerous multiple choice, true-false, and discussion questions permitting students to self-test their knowledge of each chapter. Answers and short explanations for most questions are provided in the back of the *Coursebook*. Each chapter also contains problem and project exercises designed to improve the student's knowledge of the mechanics. A set of short readings chosen to supplement the classroom teaching of important topics is also included in the *Coursebook*. Several of the readings are arranged in a debate format and cover areas of controversy in economics. Discussion questions follow each article, challenging students to demonstrate their understanding of the material and their ability to distinguish a sound argument from economic nonsense. Like the textbook, the *Coursebook* is designed to help students develop the economic way of thinking.

**Testbanks.** Two testbanks accompany the Sixth Edition. Testbank A contains approximately 3,500 multiple-choice questions, most of which have been extensively tested in the classroom. Within each chapter, the questions correspond to the major subheadings of the text. Testbank B, prepared by J. J. Bethune of Bellarmine College, provides approximately 2,000 additional multiple-choice questions. Both testbanks are available on computer diskette. The ExaMaster system accompanying the computerized testbanks makes it easy to create tests, print scrambled versions of the same test, modify questions, and reproduce the graphic questions. The new edition of the testbank contains a large number of graphic questions.

**Instructor's Manual.** The *Instructor's Manual* is divided into two parts. The first part, which is also available on computer diskette, is a detailed outline of each chapter in lecture-note form. It is designed to help instructors organize and structure their current lecture notes according to the format of the Sixth Edition of *Economics: Private and Public Choice*. Instructors can easily prepare a detailed, personalized set of notes by revising the computerized form of the notes. The second part of the *Instructor's Manual* contains teaching tips, sources of supplementary materials, and other helpful information. Part 3 provides instructors

with several games designed to illustrate and enliven important economic concepts. Suggested answers to most of the critical analysis questions that were not answered in Appendix C of the text are also provided in the *Instructor's Manual*.

**Color Transparencies.** Color transparencies of the major exhibits of the Sixth Edition have been especially prepared for overhead projectors. They are available to adopters upon request.

**Computer Simulation Package.** *ECO Talk*, a computer simulation package, is available free to adopters (and to their students for a nominal fee). *ECP Talk* consists of ten microeconomic and ten macroeconomic models designed to help users master important concepts through simulations, practice with graphics, and quizzes on the models. *ECO Talk* was developed by Michael Claudon of Middlebury College and Kipley Olson of Apple Computer. While it is not tied to a specific textbook, it contains the primary models presented in this textbook.

**Video Package.** Milton Friedman's *Free to Choose* is available in ten half-hour videotapes.

## ACKNOWLEDGMENTS

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Gary Galles of Pepperdine University provided a detailed review of every chapter. In addition, he is the author of the *Instructor's Manual* for this edition. Given his creativity, communication skills, and talent for the teaching of economics, the overall Sixth Edition package is vastly improved as the result of his contributions.

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# ***A Note to Students***

This text contains several features that we think will help you maximize (a good economics term) the returns derived from your study effort. Our past experience indicates that awareness of the following points will help you to use the book more effectively.

- Each chapter begins with a series of focus questions which communicate the central issues of the chapter. Before you read the chapter, briefly think about the focus questions, why they are important, and how they relate to the material of prior chapters.
- The textbook is organized in the form of an outline. The headings within the text are the major points of the outline. Minor headings (contained in the margins) are subpoints under the major headings. In addition, important subpoints within sections are often set off and numbered. Sometimes thumbnail sketches are used to help the reader better organize important points. Careful use of the headings and thumbnail sketches will help you better visualize the organization of the material.
- A summary appears at the end of each chapter. Use the summary as a checklist to determine whether or not you understand the major points of the chapter.
- Review of the exhibits will also provide you with a summary of each chapter. The accompanying legend briefly describes the content and analysis of each exhibit. After studying the chapter, briefly review the exhibits to ensure that you have mastered the central points.
- The key terms introduced in each chapter are defined in the margins. As you study the chapter, go over the marginal definition of each key term as it is introduced. Later, you may also find it useful to review the marginal definitions. If you have forgotten the meaning of a term introduced earlier, consult the glossary at the end of the book.
- The boxed features provide additional depth on various topics without disrupting the flow of the text. In general, the topics of the boxed features have been chosen because of their relevance as an application of the theory or because of past student interest in the topic. Reading the boxed features will supplement the text and enhance your understanding of important economic concepts.
- The Critical Analysis Questions at the end of each chapter are intended to test your understanding of the economic way of thinking. They provide you with another opportunity to review each chapter. Answers to approximately 40 percent of these questions are provided in Appendix B.

- If you are having trouble, be sure to obtain a *Coursebook* and work the questions and problems for each chapter. The *Coursebook* also contains the answers to the multiple-choice questions and a brief explanation of why an answer is correct (and other choices incorrect). In most cases, if you master the concepts of the test items in the *Coursebook*, you will do well on the quizzes and examinations of your instructor.

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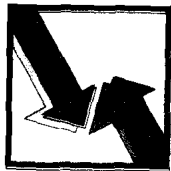
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