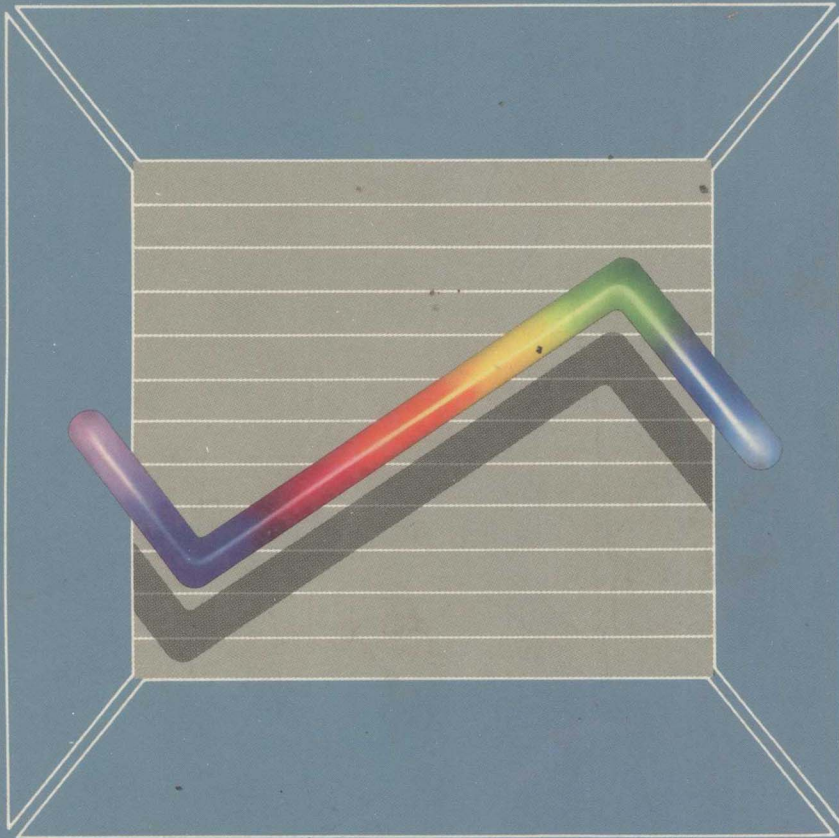


ECONOMICS

PRINCIPLES AND POLES

MICROECONOMICS



F O U R T H E D I T I O N

WILLIAM J. BAUMOL
ALAN S. BLINDER

ECONOMICS

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MICROECONOMICS

F O U R T H E D I T I O N

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To my four children,
Ellen, Daniel,
and now Sabrina and Jim
W.J.B.

For Scott, now of age to read this book,
and William, who prefers Garfield
A.S.B.

Preface

For decades, the “principles of economics” book has been expected to codify the entire discipline of economics. In recent years, this has become at once more difficult and more imperative. The explosion of economic knowledge has made it impossible to put all of economics between two covers. But at the same time, more and more public policy issues either are basically economic in nature or involve important economic considerations. Intelligent citizens can no longer afford to be innocent of economics.

The preparation of this Fourth Edition continued to be guided by this dilemma. We have studiously avoided the encyclopedic approach and abandoned the fiction, so popular among textbook writers, that literally everything is of the utmost importance. Since students are sufficiently intelligent to see through this ruse in any event, we have tried to highlight those important ideas that are likely to be of lasting significance—principles that you will want to remember long after the course is over because they offer insights that are far from obvious, because they are of practical importance, and because they are widely misunderstood by intelligent laymen. A dozen of the most important of these ideas have been selected as **12 Ideas for Beyond the Final Exam** and are called to your attention when they occur through the use of the book’s logo. 

All modern economics textbooks abound with “real world” examples, but we have tried to go beyond this, to elevate the examples to preeminence. For in our view, the policy issue or everyday economic problem ought to lead the student naturally to the economic principle, not the other way around. For this reason, many chapters start with a real policy issue or a practical problem that may seem puzzling or paradoxical to noneconomists, and then proceed to describe the economic analysis required to remove the mystery. In doing this, we have tried to utilize technical jargon and diagrams only where there is a clear need for them, never for their own sake.

Still, economics is a somewhat technical subject and, except for a few rather light chapters, this is a book for the desk, not for the bed. We have, however, made strenuous efforts to simplify the technical level of the discussion as much as we could without sacrificing content. Fortunately, almost every important idea in economics can be explained in plain English, and this, in general, is how we have tried to explain them. Yet, even while reducing the technical difficulty of the book, we have incorporated some elements of economic analysis that have traditionally been left out of introductory books but that are really too important to omit.

One example is our treatment of how the market mechanism is able, under ideal circumstances, to allocate society’s resources in the most efficient manner possible. Many introductory textbooks, thinking the topic too difficult for beginning students, give little more than some general hints about this important result. We offer a genuine proof and an extensive discussion of precisely what the result does—and does not—imply about the efficiency of real-world market economies.

Changes from the Third Edition

The discussion continues to be organized around a central theme that we believe deals with the most significant lessons to be learned in an introductory economics course: what a market system does well, and what it does poorly.

Thus Part 1 introduces the central theme and some of the fundamental ideas of economics (such as scarcity, opportunity cost, markets, and prices). Then Part 2 acquaints students with the central analytical tools of microeconomics and uses them to explain how both consumers (Chapters 5 and 6) and producers (Chapters 7 and 8) make decisions that best serve their own interests. Part 3 examines how these decisions interact in the marketplace and provides an extensive examination of the virtues and vices of free markets. The early chapters of Part 3 (Chapters 9 and 10) extol the remarkable accomplishments of an idealized system of markets, while the later chapters (Chapters 11–12) discuss some of the market system's principal failings. In this way, Part 3 sets the stage for Parts 4 and 5, in which we discuss where, why, and how the government intervenes in the economy.

Much of this material has been rewritten and/or reorganized since the Third Edition, partly in response to many extremely useful suggestions we have had from readers. Difficult points are explained more patiently, and there are more examples and graphs than in the Third Edition. Much in the “core” microeconomic chapters (Chapters 5–8) has been extensively revised. In particular, at the suggestion of a number of commentators, the discussion of the technicalities of the elasticity formula in Chapter 6 has been simplified, and we have introduced the important distinction between fixed and sunk costs in Chapters 7 and 8. A misleading association between scale economies and declining average costs that occurred in the previous edition has also been avoided.

The policy-oriented chapters have been updated to reflect new developments in regulatory (Chapter 15), antitrust (Chapter 16), and environmental (Chapter 18) policy. The tax revision of 1986 is, of course, incorporated into Chapter 17 and elsewhere. Finally, we introduce a new feature: “At the Frontier,” offering students a taste of newer areas of economic analysis. Under this heading we include boxed inserts on principal-agent and asymmetric information problems, strategic-entry deterrence models in game theory, and the theory of contestable markets.

Studying Principles of Economics

Whatever the nature of your course, we would like to offer one suggestion. Unlike some of the other courses you may be taking, principles of economics is cumulative—each week's lesson builds on what you have learned before. You will save yourself a lot of frustration (and also a lot of work) if you keep up on a week-to-week basis. To help you do this, there is a chapter summary, a list of important terms and concepts, and a selection of discussion questions to help you review at the end of each chapter. In addition to these aids, many students will find the

Study Guide, designed specifically to accompany this text by Professor Craig Swan, helpful as a self-testing and diagnostic device. When you encounter difficulties in the *Study Guide*, you will know which sections of the text you need to review.

Note to the Instructor

In trying to improve the book from one edition to the next, we rely heavily on our own experiences as teachers. But our experience using the book is minuscule compared with that of the hundreds of instructors who use it nationwide. If you encounter problems, or have suggestions for improving the book, we urge you to let us know by writing to either one of us in care of Harcourt Brace Jovanovich, College Department, 1250 Sixth Avenue, San Diego, California 92101. Such letters are invaluable, and we are glad to receive them, even if they are critical.

What follows is a set of suggested course outlines.

OUTLINE FOR A ONE-SEMESTER COURSE IN MICROECONOMICS

| Chapter Number | Title |
|----------------|---|
| 1 | What Is Economics? |
| 2 | The Use and Misuse of Graphs |
| 3 | Scarcity and Choice: <i>The Economic Problem</i> |
| 4 | Supply and Demand: An Initial Look |
| 5 | Consumer Choice and the Individual's Demand Curve |
| 6 | Market Demand and Elasticity |
| 7 | Input Decisions and Production Costs |
| 8 | Output–Price Decisions: The Importance of Marginal Analysis |
| 9 | The Firm and the Industry Under Perfect Competition |
| 10 | The Price System and the Case for Laissez Faire |
| 11 | Monopoly |
| 12 | Between Competition and Monopoly |
| 13 | The Market Mechanism: Shortcomings and Remedies |
| 14 | Real Firms and Their Financing: Stocks and Bonds |
| 15 | Limiting Market Power: Regulation of Industry |
| 16 | Limiting Market Power: Antitrust Policy |
| 17 | Taxation, Government Spending, and Resource Allocation |
| 19 | Pricing the Factors of Production |
| 20 | Labor: The Crucial Input |

Plus Any Two of the Following:

| | |
|----|--|
| 18 | Environmental Protection and Resource Conservation |
| 21 | Poverty, Inequality, and Discrimination |
| 22 | The Economics of Karl Marx |
| 23 | Comparative Economic Systems: What Are the Choices? |
| 24 | Dissenting Opinions: Conservative, Moderate, and Radical |

OUTLINE FOR A ONE-QUARTER COURSE IN MICROECONOMICS

| Chapter Number | Title |
|----------------|--|
| 3 | Scarcity and Choice: <i>The Economic Problem</i> |
| 4 | Supply and Demand: An Initial Look |
| 5 | Consumer Choice and the Individual's Demand Curve |
| 6 | Market Demand and Elasticity |
| 7 | Input Decisions and Production Costs |
| 8 | Output–Price Decisions: The Importance of Marginal Analysis |
| 9 | The Firm and the Industry Under Perfect Competition |
| 10 | The Price System and the Case for Laissez Faire |
| 11 | Monopoly |
| 12 | Between Competition and Monopoly |
| 13 | The Market Mechanism: Shortcomings and Remedies |
| 14 | Real Firms and Their Financing: Stocks and Bonds |
| 17 | Taxation, Government Spending, and Resource Allocation |
| 19 | Pricing the Factors of Production |
| 20 | Labor: The Crucial Input |

With Thanks

Finally, and with great pleasure, we turn to the customary acknowledgments of indebtedness. Ours have been accumulating now through four editions. In these days of specialization, not even a pair of authors can master every subject that an introductory text must cover. Our friends and colleagues Charles Berry, Rebecca Blank, William Branson, Lester Chandler, Gregory Chow, Avinash Dixit, Robert Eisner, Stephen Goldfeld, Claudia Goldin, Ronald Grieson, Daniel Hamermesh, Peter Kenen, Melvin Krauss, Arthur Lewis, Burton Malkiel, Edwin Mills, Janusz Ordover, Uwe Reinhardt, Harvey Rosen, Carl Shapiro, Hans Soderstrom, Laura Tyson, and Martin Weitzman have all given generously of their knowledge in particular areas over the course of four editions. We have learned much from them, and only wish we had learned more.

Many economists at other colleges and universities offered useful suggestions for improvements, many of which we have incorporated into the Fourth Edition. We wish to thank J. David Bowman of State University of New York—Oswego, Gerald Breger of University of South Carolina, Hsin Chang of University of Michigan, Carol Clark of Guilford College, Elizabeth Crowell of University of Michigan, Elizabeth Dickhaus of University of Missouri—Columbia, Patricia Euznet of University of Central Florida, Marianne Felton of Indiana University, Richard Fritz of University of Central Florida, Phillip Gilbert of Mira Costa College, Jonathan Goldstein of Bowdin College, Joseph Guerin of Saint Joseph's University, Thomas Hamer of Glassboro State College, James Hanson of Willamette University, Richard Harmstone of Pennsylvania State University, Benjamin Hitchner of Glassboro State College, John Isbister of University of California—Santa Cruz, Hassan Khademan of University of Missouri—St. Louis, Wolfgang Mayer of University of Cincinnati, John Mogab of Southwest Texas State University, David Ramsey of Illinois State University, Neil Reznik of Community College of Philadelphia, Steven Rock of Illinois Institute of Technology, Gary Sellers of University of Akron, Scott Sumner of Bentley College, Robert Thomas of Iowa State University, Roger Trenary of Kansas State University, Wayne Wangsness of Luther College, Walter Wessels of North Carolina State University, Travis Wilson of DeKalb Community College, and Anthony Zambelli of Cuyamaca College.

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We were, of course, most gratified by a number of spontaneous and kind letters from student readers. Since it is for such readers that the book is primarily intended, no other comments have meant as much to us.

The book you hold in your hand was not done by us alone. The fine people at Harcourt Brace Jovanovich, including Mimi Egan, Margie Rogers, Bruce

Daniels, Lynn Edwards, Rebecca Lytle, and Diane Pella, worked hard and well to turn our manuscript into the book you see. We appreciate their efforts.

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William J. Baumol
Alan S. Blinder

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*Some of the Ideas for Beyond the Final Exam are in this textbook; others are in *Macroeconomics: Principles and Policy* by Baumol and Blinder.

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