

SECOND EDITION  
**ECONOMICS**  
THOMPSON

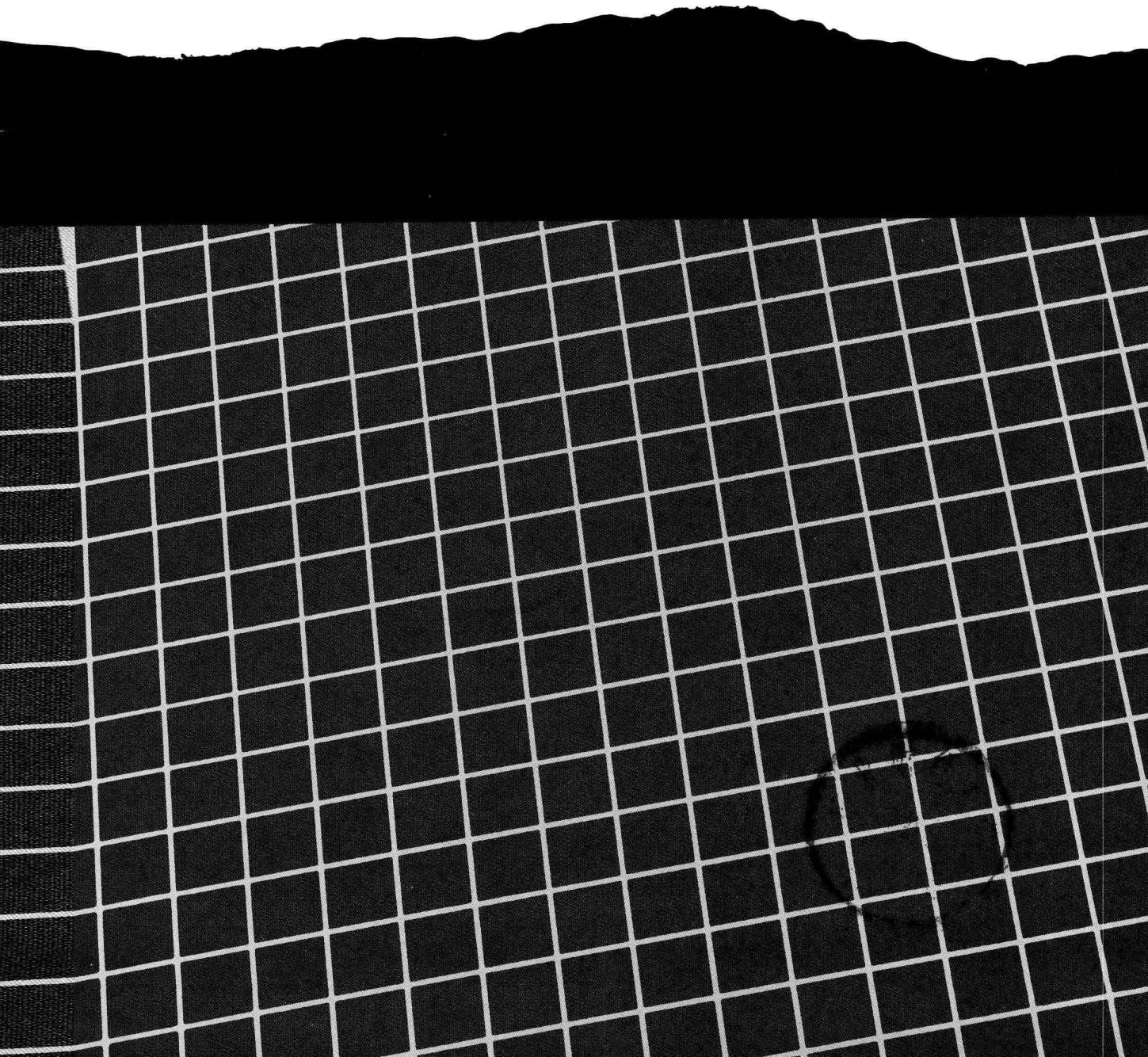




**SECOND EDITION**

# **ECONOMICS**

**ALLEN R. THOMPSON**  
UNIVERSITY OF NEW HAMPSHIRE



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*Reprinted with corrections, May 1988*

**Library of Congress Cataloging-in-Publication Data**

Thompson, Allen R.

Economics.

Includes index.

1. Economics. I. Title.

HB171.5.T33 1988 330 87-912  
ISBN 0-201-09682-X

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CDEFGHJ-RN-898

# P R E F A C E

## T O T H E STUDENT

Although only a few beginning students go on to become professional economists, everyone faces situations in which economic reasoning is very important. For example, economic reasoning can help you identify the benefits and costs of choosing between taking a job immediately after graduation or continuing your education. Businesses rely on economic reasoning in deciding whether to build a new plant or produce a new product. And, as citizens, we make political choices that are based in part on economic policies proposed by politicians. An understanding of economics can help you make more informed choices.

The aim of this textbook is to teach you economic reasoning. But even a casual reading of the newspapers reveals wide disagreements among professional economists. You may ask yourself, “How can I learn to use economic reasoning when economists themselves can’t seem to agree on what is reasonable?” Despite the impression created by the media, economists do agree on many points. In particular, economists share some important and fundamental principles that constitute the economic way of thinking. These principles are the major focus of this book and the key to understanding a wide variety of economic issues.

As you approach your study of economics, try to focus on the practical applications of economic principles and economic reasoning. For example, when you encounter a new concept, ask yourself “How can I use this principle to answer economic questions in my own life?” Students who take this approach are not only the most successful students, but they come away from the course knowing how to apply what they have learned to their own lives.

Second, as you can see by flipping through the pages of this textbook, economic analysis relies heavily on graphs to clarify abstract concepts. I urge you to study the introduction to graphs in the appendix following Chapter 1. Since graphs are important both to learning and applying economic principles, I have carefully explained each new type of graph when it is introduced. (The *Workbook* that accompanies this text contains an introductory chapter devoted to graphs. In addition, the *Workbook* contains a special section on each new type of graph

introduced in the text as well as considerable applications that allow you to practice reading and drawing graphs.)

Almost all graphs in this textbook have a numerical scale and all are color-coded: Demand-related curves are blue, while supply-related curves appear in red. In some exhibits the same information appears in both tabular and graphical form to facilitate understanding the graphs and the economic principles they illustrate. Be sure you understand how to read each type of graph and how to draw graphs yourself.

At first you may be perplexed by the new terms you encounter in introductory economics. However, this vocabulary was not developed to confuse you, but to enable economists and students to speak precisely. Learning this vocabulary is critical to learning economics. Each time a key economic term is introduced, it appears in bold print with a definition in the margin. For easy review, there is a glossary of key terms in the back of the textbook.

**One final note:** Economics may not be the easiest subject you ever tackle, but it is one of the most exciting and useful. In fact, I make a standing offer to my students. If they can find elements of my course that have no practical use, I promise to delete that material from the course and award them bonus points on their next exam. I can't offer the same bonus to you, but I will promise to delete material with no practical use from subsequent editions of this textbook. I don't, of course, expect that you will find any nonpractical concepts. But I believe that if you always look for the practical use of the concepts you encounter, your exam grades will be satisfactory even without those extra bonus points.

## T O T H E INSTRUCTOR

The challenge in writing about or teaching principles of economics is to demonstrate the power of economics as a tool for understanding our world. I can think of no better way to convey that power than by proceeding with two parallel goals in mind. First, show the broad spectrum of problems that economics can help us solve, from increasing U.S. competitiveness to budget-balancing. At the same time, teach students economic analysis. Enable them to put this powerful tool to work for themselves.

My objective is not to prepare students for careers as professional economists but to teach them how to think like economists. One strategy for achieving this goal is to teach the basics very well, so that certain economic principles become more than ideas—they become actual perspectives on the world. In the text, I focus the students' attention on the most fundamental principles of economics and return to and extend these principles again and again. Concepts such as demand, supply, opportunity cost, rational choice, and the role of expectations are introduced early, explained carefully, and then constantly applied to new situations. Students quickly get into the habit of looking for opportunities to put economic analysis to work.

In preparing this revision, I drew on the advice and experience of many readers of the first edition of *Economics*. The book you are now reading benefitted not only from a thorough review of every draft of the manuscript, but also from a comprehensive evaluation by users of the previous edition. Many students and instructors who were using the first edition agreed to submit critiques on a regular

basis, assessing the effectiveness of the presentation, the graphs, and the other pedagogical features. Their valuable input has allowed me to pinpoint features to retain and strengthen and others to add or revise.

## Class-Tested Features

Several highly praised qualities of the first edition still distinguish this text. These features include careful step-by-step explanations of important concepts and the frequent *application* of these concepts, clear and readable graphs, abundant real-world examples to illustrate theory, built-in flexibility, and a distinctive, uncluttered design.

***A focus on core principles.*** As a teacher of economics, I have successfully used a unifying, step-by-step approach to help students grasp fundamental principles. Whenever I introduce a new concept, I carefully explain the logic behind it and its connection to previously learned material. For example, I present consumer choice, producer choice, and social choice as extensions of the principle of rational choice in different contexts rather than as discrete economic rules. And by carefully developing and then returning to basic themes like efficiency, price stability, and economic growth, the text enables students to see the common logic underlying apparently different economic decisions.

***Graphs as analytical tools.*** A graph is the economist's shorthand for depicting an economic relationship. No single element in this textbook has received more attention than the treatment of the graphs. Several features in the text help students overcome the problems they commonly have with graphs. An appendix after Chapter 1 provides a simple introduction to the use of graphs. Throughout the book, the exhibits themselves are color-coded: Demand-related curves are blue, supply-related curves are red. This device helps students build on previously learned material. Almost all graphs contain background grids and display numbers on both axes. Students generally find such graphs more accessible than the type displaying only abstract symbols. Finally, any graph used to present a new economic concept is accompanied by a related table, enabling students to see that both the graph and table contain the same basic information.

The *Workbook*, available with *Economics, Second Edition*, also contains a chapter on graphs, a guide to each new type of graph introduced, and a host of exercises that ask the student to read, interpret, and utilize graphs to answer economic questions.

***Applications and other pedagogy.*** I rely on applications and examples to illustrate how economic concepts help us understand the real world. Many are woven right into the text. We examine the effect of competition in a dynamic setting like the compact disc industry, or we take a look at the impact of the 1986 tax reform on saving and investment behavior.

We have two kinds of boxes in *Economics*. "Cases in Point," a feature retained from the first edition, are brief case studies that illustrate a specific economic concept. One case examines the fixed and variable costs of driving. Another looks at historical examples of expansionary gaps. The "Cases in Point" are always extensions, or clarifications through example, of topics covered in the text. Many new "Cases in Point" have been added to the second edition. An exciting new

feature of the second edition is a series of brief articles called “Economic Encounters.” These explore the economic aspects of trends and happenings in our world.

The textbook is full of useful pedagogical features. Chapters open with a series of “Questions to Consider” that alert students to the relevance of the material in the chapter. Definitions of new terms and recaps of important points are found in the margins. Figure captions fully explain each graph and diagram. The illustration program alone serves as a visual digest of the analytical content of each chapter. Coming at the end of the chapter are numbered summaries and a large variety of questions and problems designed to get students to apply the economic concepts presented in the text.

**Flexibility.** Since no two instructors teach the principles course in exactly the same way, I consider it important to maintain the text’s great flexibility. My own preference in teaching economics is to build from the individual to the aggregate. So, as in the previous edition, microeconomics precedes macroeconomics. However, the book can as easily be used in a class in which macro is treated first. I have taken great care to make sure that no discussion in one half of the book depends upon material in the other half. Furthermore, while the text contains core chapters that are central to all principles courses, there are several optional chapters from which instructors can pick and choose.

Thirteen chapter-end appendixes offer the reader a more detailed look at topics covered in the main text. Indifference analysis, discounted present value, the algebra of the multiplier effect and joint equilibrium in goods and money markets are all covered in these optional sections, providing the instructor and student with additional means of approaching key economic principles. Boxes and end-of-chapter problems offer still other opportunities to explore economic topics in greater detail. This textbook was designed so that a variety of paths could be taken through it. Its flexibility allows it to suit many different course syllabi. Just as significant, however, is the capability of this textbook, through appendixes, boxes, and problems, to challenge the more motivated student.

## What’s New in This Edition

*Economics, Second Edition* offers several exciting new features, including a restructured treatment of macroeconomics, a new approach to economic policy issues, the addition of “Economic Encounters,” and a special emphasis on international economics.

**Presenting macroeconomics.** To offer a contemporary and cohesive approach to macroeconomics at the principles level is a particular challenge. My objective in restructuring this half of the textbook was to simplify and condense the presentation while retaining full coverage of all important macroeconomic concepts. As a result, there are fewer chapters than in the previous edition. Yet there are more examples, both historical and current, of macroeconomics in action.

I have maintained a contemporary approach to macroeconomics, emphasizing the role of expectations and providing a full discussion of the aggregate demand and aggregate supply model. I introduce the AD/AS model early, actually in the first chapter of the macroeconomics section, but I fully develop it in a new, separate



chapter only after all the elements of the model are fully explained. I then apply the AD/AS model to macroeconomic policies.

***A new approach to economic policy issues.*** *Economics, Second Edition* takes a major stride toward offering a more balanced and unified approach to economic policy than one typically finds in principles textbooks. Rather than devoting entire chapters to a very few individual policy issues such as agriculture or the federal budget deficit, or at the other extreme, touching on a wide variety of issues only briefly as examples in the text, I have developed two new chapters, one pertaining to microeconomics and one to macroeconomics, which contain several short essays on economic policies.

Each of these chapters begins with an introduction that explains how economists analyze policy issues and provides a general framework for policy analysis. The introduction is followed by a series of individual policy cases, averaging four to five pages each, that then apply that analytical framework. The microeconomics policy chapter includes issues like agricultural price supports and airline deregulation. On the macroeconomic side, I include sections on the budget deficit and international competitiveness, to name just two.

Naturally, the discussion of policy has not been confined to these chapters. The rationales and practical limits on government action, stabilization policy, public choice theory, market failure, and many examples of government policy in action are discussed throughout the text.

***Economic Encounters.*** We have added a series of short pieces to the textbook that further illustrate the economic content of the world around us. These two-page articles focus on economic aspects of our political, social, and commercial lives. They ask us to consider events at the gas station, on Wall Street, or in South Africa, always emphasizing that there are more sides to an economic story than might at first be apparent. Why does unemployment persist in a nation where almost any newspaper contains numerous help-wanted advertisements? What are the pros and cons of hostile corporate takeovers? What must it be like to live in a country experiencing hyperinflation? “Economic Encounters” bring us face to face with the economic forces that shape people’s lives.

***A spotlight on international economics.*** International trade and finance is a crucial component of today’s economy. It has been said that there are no closed economies in the world, only closed economists. If students are to leave the principles course with a proper understanding of the workings of the U.S. economy, then they must be aware that the United States is only one part of an increasingly interrelated world economy.

In this edition, international economics is not just a topic relegated to the back of the textbook; rather it is integrated throughout. I apply the principles of exchange to international trade in the introductory chapters. A simple circular-flow model in Chapter 6 shows both trade and capital flows. Examples drawn from the international economy abound. Throughout the text, students see that foreign firms compete with U.S. firms, that foreign individuals, businesses, and governments play a major role in U.S. financial markets and purchase U.S. goods and services, and that it is no longer possible to dissociate economic events in other countries from events in our own. Additionally, three chapters at the end of the book offer more in-depth discussions of international trade, finance, comparative economic systems, and economic development.



## Supplements Available to Accompany This Textbook

**Workbook.** This supplement, written by Neil Niman of the University of New Hampshire and myself, is designed to enhance student comprehension. Like many study guides, it contains a list of learning objectives, fill-in questions covering key terms, and multiple-choice questions to test the student's understanding of the basic concepts in each chapter. A unique feature is a guide to each new graph encountered by the student, explaining what it shows and how to read and interpret the economic principles illustrated. Other features are "Avoid These Common Mistakes" and "Some Useful Tips." But the wealth of applications contained in this volume makes it more than a study guide. Students are given practice reading and drawing graphs, using data to make economic decisions, and solving numerical problems. The emphasis is not just on developing mechanical skills; students are asked to interpret data, make decisions, or otherwise show an understanding of the economic principles.

**Instructor's Manual.** Prepared by Richard Burdekin of the University of Miami and myself, this supplement contains answers to the Questions for Discussion, points of special emphasis, teaching hints and current applications, and other useful information.

**Test Item File.** A test item file containing over 2,000 multiple-choice questions has been prepared by Susan McHargue of Southern Methodist University, Kari Battaglia of North Texas State University, Teri Riley of Youngstown State University, and Jeffrey Wrase of Arizona State University. The file is available on hard copy and computer disk for ease of test preparation.

**Transparencies.** Approximately 200 color acetates developed from graphs in the text are available to adopters.

**Graphecon II.** An interactive computer tutorial written by Lee D. Olvey and James R. Golden of the U.S. Military Academy of West Point makes full use of computer graphics capabilities. This powerful program fully complements the text and offers students valuable practice in graphing and in putting economic concepts to work. Four instructional disks prompt the student to analyze problems in supply and demand, microeconomics, macroeconomics, and international trade. This enhanced version of *Graphecon* strongly reinforces correct answers and offers careful explanations in response to incorrect answers. Also, users have extensive control over the graphics on the screen, enabling them to see immediately the effect of new information on economic relationships.

## ACKNOWLEDGMENTS

This book owes a great deal to other people. I would like to thank the students in my classes and my colleagues at the Whittemore School of Business and Economics—especially Manly Irwin, Neil Niman, Robert Puth, and Dwayne Wrightsman. I have learned much from each of them and they may well find some of their favorite examples included in the text. In addition, a former colleague, Michael Conti, along with the many reviewers of the first and second editions, provided many helpful suggestions.

I certainly owe a good deal to the professional assistance provided by the editorial and production staff at Addison-Wesley, including Debra Hunter and Steve Mautner who provided overall editorial direction; to Linda Bedell and Darlene Bordwell, whose development assistance was invaluable; to Dick Morton and Meredith Nightingale, who developed and produced the artwork; and to Sherry Berg, who skillfully guided the production of the manuscript. Working with such a professional and personable group was both a pleasure and an education.

Last, but certainly not least, I must acknowledge the contributions of my family—Dianne, Chris, Jen, and Lindsay. My wife Dianne not only assisted in word-processing, but read the manuscript in every phase, providing many useful suggestions. I cannot imagine completing this project without their support, encouragement, and patience.

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

## P A R T ONE

Introduction to Economics	1
<b>CHAPTER 1</b> The Economic Way of Thinking	3
<b>CHAPTER 2</b> Scarcity and Economic Choice	25
<b>CHAPTER 3</b> Laws of Demand and Supply	45
<b>CHAPTER 4</b> Elasticity of Demand and Supply	75
<b>CHAPTER 5</b> Market Economies and Resource Allocation	96
<b>CHAPTER 6</b> Overview of the U.S. Economy	120

## P A R T TWO

Behind Demand and Supply	145
<b>CHAPTER 7</b> Consumer Choice and Demand	147
<b>CHAPTER 8</b> Producer Choice and Costs of Production	173
<b>CHAPTER 9</b> Producer Choice and Economic Decisions	206

## P A R T THREE

Market Structure and Market Power	231
<b>CHAPTER 10</b> Competition and Efficiency	233
<b>CHAPTER 11</b> Monopoly and Economic Inefficiency	258
<b>CHAPTER 12</b> Imperfect Competition	286

## P A R T FOUR

Resource Markets	311
<b>CHAPTER 13</b> Demand and Supply in Resource Markets	313
<b>CHAPTER 14</b> Capital Resources and Financial Markets	336
<b>CHAPTER 15</b> Labor Markets and Collective Bargaining	358

**P A R T  
FIVE**

Microeconomic Role of Government	383
<b>CHAPTER 16</b> Microeconomics of Public Finance	385
<b>CHAPTER 17</b> Government Regulation and Economic Efficiency	411
<b>CHAPTER 18</b> Income Distribution and Equity	441
<b>CHAPTER 19</b> Microeconomic Issues and Government Policies	468

**P A R T  
SIX**

Macroeconomic Measures and Models	497
<b>CHAPTER 20</b> Introduction to Macroeconomics	499
<b>CHAPTER 21</b> Gross National Product: Measuring Aggregate Output	532
<b>CHAPTER 22</b> Aggregate Expenditures and Equilibrium Output	559
<b>CHAPTER 23</b> Changes in Spending and the Multiplier Effect	591

**P A R T  
SEVEN**

Money, Banking, and Economic Activity	615
<b>CHAPTER 24</b> Money and the Banking System	617
<b>CHAPTER 25</b> Money and Economic Activity	640
<b>CHAPTER 26</b> Aggregate Demand and Aggregate Supply	660

**P A R T  
EIGHT**

Macroeconomic Role of Government	687
<b>CHAPTER 27</b> Macroeconomic Policy: Theory and Practice	689
<b>CHAPTER 28</b> Unemployment: Some Microeconomic Foundations	719
<b>CHAPTER 29</b> Inflation and Unemployment	738
<b>CHAPTER 30</b> Economic Growth: Increasing Potential GNP	764
<b>CHAPTER 31</b> Macroeconomic Issues and Government Policies	790

**P A R T  
NINE**

International Economics	817
<b>CHAPTER 32</b> International Trade	819
<b>CHAPTER 33</b> International Finance	844
<b>CHAPTER 34</b> Comparative Economic Systems and Economic Development	866

# C O N T E N T S

## P A R T **ONE**

### Introduction to Economics

<b>CHAPTER 1</b>	The Economic Way of Thinking	<b>3</b>
	<b>WHAT IS ECONOMICS?</b>	<b>4</b>
	Economics Is a Study of the Real World	5
	Economics Is a Study of Scarcity	5
	Economics Is a Study of Choices	6
	Economics Is a Study of Trade or Exchange	6
	Economics Is a Study of Organization	7
	Microeconomic and Macroeconomic Perspectives	8
	<b>THE LANGUAGE OF ECONOMICS</b>	<b>9</b>
	Resources	9
	Opportunity Cost	9
	<b>METHODS OF ECONOMIC ANALYSIS</b>	<b>10</b>
	Graphic Models	11
	Using Models to Predict Economic Outcomes	11
	Avoiding Logical Errors	13
	Maintaining Objectivity: Facts versus Opinion	14
	<b>WHY DO ECONOMISTS DISAGREE?</b>	<b>14</b>
	What Are the “Facts”?	15
	Which Theory Is Best?	15
	What Are the Benefits and Costs?	15
	<b>CONCLUSION</b>	<b>16</b>
	<b>APPENDIX TO CHAPTER 1 USE OF GRAPHS</b>	<b>18</b>



<b>CHAPTER 2</b>	Scarcity and Economic Choice	<b>25</b>
	<b>IMPLICATIONS OF SCARCITY</b>	<b>26</b>
	Competition and Rationing	26
	Economic Goals	27
	Production Possibilities	29
	<b>ECONOMIC CHOICE</b>	<b>35</b>
	Self-Interest	35
	Minimizing Costs and Maximizing Benefits	36
	Rational Expectations	36
	Marginal Costs and Benefits	36
	Economic Approach to Decision Making	37
	Rational Public Choice	38
	<b>A Case in Point How Many Prisons to Build?</b>	<b>39</b>
	<b>RATIONAL CHOICE IN ACTION</b>	<b>40</b>
	<b>CONCLUSION</b>	<b>41</b>
 <b>CHAPTER 3</b>	 Laws of Demand and Supply	 <b>45</b>
	<b>DEMAND</b>	<b>47</b>
	Law of Demand	48
	Demand Schedules and Demand Curves	48
	Changes in Demand and Quantity Demanded	50
	Determinants of Product Demand	51
	Demand and Quantity Demanded Reconsidered	54
	Changes in Relative Prices	54
	<b>SUPPLY</b>	<b>55</b>
	Law of Supply	55
	Supply Schedules and Supply Curves	55
	Changes in Supply and Quantity Supplied	57
	Determinants of Supply	58
	Supply and Quantity Supplied Reconsidered	59
	<b>MARKET EQUILIBRIUM</b>	<b>60</b>
	Shortage	61
	Surplus	62
	Changes in Market Conditions and Equilibrium Prices	62
	Changes in Equilibrium Reconsidered	65
	<b>GOVERNMENT PRICE-SETTING POLICIES</b>	<b>65</b>
	Ceiling Prices	66
	Support Prices	66
	<b>CONCLUSION</b>	<b>67</b>
	<b>A Case in Point Effects of Price Ceilings and Price Supports</b>	<b>68</b>
	<b>APPENDIX TO CHAPTER 3 ALGEBRA OF MARKET EQUILIBRIUM</b>	<b>71</b>
 <b>CHAPTER 4</b>	 Elasticity of Demand and Supply	 <b>75</b>
	<b>PRICE ELASTICITY OF DEMAND</b>	<b>76</b>
	Price Elasticity as a Relative Concept	78
	Price Elasticity of Demand and Total Revenue	82
	Two Extreme Cases	84
	Determinants of Price Elasticity of Demand	85

	<b>A Case in Point Who Pays a Sales Tax?</b>	86	
	Price Elasticity of Demand in Action	88	
	<b>OTHER TYPES OF ELASTICITY</b>		89
	Price Elasticity of Supply	89	
	Income Elasticity of Demand	90	
	Cross Elasticity of Demand	91	
	Supply and Income Elasticity in Action	92	
	<b>CONCLUSION</b>		93
<b>CHAPTER 5</b>	<b>Market Economies and Resource Allocation</b>		96
	<b>CIRCULAR FLOW OF ECONOMIC ACTIVITY</b>		97
	Circular-Flow Model	98	
	Role of Money	100	
	<b>A Case in Point The Economic Organization of a POW Camp</b>	100	
	Resource Markets and Product Markets	101	
	<b>MARKETS: SELF-INTEREST AND RATIONAL CHOICE</b>		102
	Self-Interest: The Invisible Hand	102	
	Households and Rational Choice	103	
	Businesses and Rational Choice	103	
	Market Prices and Opportunity Costs	103	
	Resource Allocation in Action	104	
	<b>MARKETS, ECONOMIC QUESTIONS, AND GOALS</b>		107
	What to Produce and the Goal of Allocative Efficiency	107	
	How to Produce and the Goal of Technical Efficiency	108	
	For Whom to Produce and the Goal of Equity	109	
	<b>CAN THE INVISIBLE HAND FAIL?</b>		110
	Private Property Rights	111	
	Competition	111	
	Information	112	
	Resource Mobility	112	
	<b>A Case in Point The Ballpoint Pen Industry</b>	113	
	Macroeconomic Instability	113	
	Different Economic Goals and Economic Views	114	
	<b>CONCLUSION</b>		114
	<b>ECONOMIC ENCOUNTERS Labor Mismatch: Balancing Demand and Supply</b>		118
<b>CHAPTER 6</b>	<b>Overview of the U.S. Economy</b>		120
	<b>THE PRIVATE SECTOR: BUSINESS</b>		121
	Role of Business Firms	121	
	Size of Business Organizations	123	
	Types of Business Organizations	124	
	Classification and Grouping of Businesses	126	
	Business Finances	127	
	<b>THE PRIVATE SECTOR: HOUSEHOLDS</b>		129
	Size and Characteristics of the U.S. Population	129	
	Sources of Personal Income	130	
	Distribution of Personal Income	132	

<b>THE PUBLIC SECTOR</b>	<b>133</b>
Role of Government	134
Government and Rational Choice	138
Size and Nature of the Public Sector	138
Size of Government: International Comparisons	140
<b>THE FOREIGN SECTOR</b>	<b>140</b>
Imports and Exports	141
International Trade and Capital Flows	141
<b>CONCLUSION</b>	<b>143</b>

## **PART TWO**

### Behind Demand and Supply

<b>CHAPTER 7</b>	<b>Consumer Choice and Demand</b>	<b>147</b>
	<b>RATIONAL CHOICE AND CONSUMER DECISIONS</b>	<b>148</b>
	<b>A Case in Point Economic Costs and Consumer Choice</b>	<b>149</b>
	<b>MARGINAL UTILITY AND CONSUMER DEMAND</b>	<b>150</b>
	Total and Marginal Utility	150
	Law of Diminishing Marginal Utility	150
	Marginal Utility and Demand	152
	Individual Demand and Market Demand	154
	Equimarginal Principle and Consumer Choice	155
	Criticisms of Marginal Utility Theory	159
	Consumer Demand and Consumer Surplus	159
	<b>CONSUMER CHOICE AND THE LAW OF DEMAND</b>	<b>161</b>
	Income and Substitution Effects of a Price Change	161
	<b>CONCLUSION</b>	<b>162</b>
	<b>APPENDIX TO CHAPTER 7 INDIFFERENCE THEORY AND CONSUMER CHOICE</b>	<b>164</b>
 <b>CHAPTER 8</b>	 <b>Producer Choice and Costs of Production</b>	 <b>173</b>
	<b>RATIONAL CHOICE AND PRODUCER DECISIONS</b>	<b>174</b>
	Maximizing Profit	174
	Opportunity Cost and Economic Profit	175
	<b>PRODUCTION AND COSTS IN THE SHORT RUN</b>	<b>176</b>
	Short-Run and Long-Run Decisions	177
	Variable Resources and Short-Run Output	177
	Increasing and Diminishing Marginal Returns	179
	Productivity and Product Costs in the Short Run	181
	Product Costs and Short-Run Cost Curves	183
	<b>A Case in Point Average Total Cost and Tuition Scholarships</b>	<b>186</b>
	<b>TECHNICAL EFFICIENCY AND OPTIMAL RESOURCE MIX</b>	<b>186</b>
	Cost Minimization and the Equimarginal Principle	188
	<b>COSTS AND ECONOMIES OF SCALE IN THE LONG RUN</b>	<b>188</b>
	<b>A Case in Point Economic Profit for Farmer Al Greene</b>	<b>189</b>
	Long-Run Costs	190
	Economies and Diseconomies of Scale	191
	<b>CONCLUSION</b>	<b>195</b>