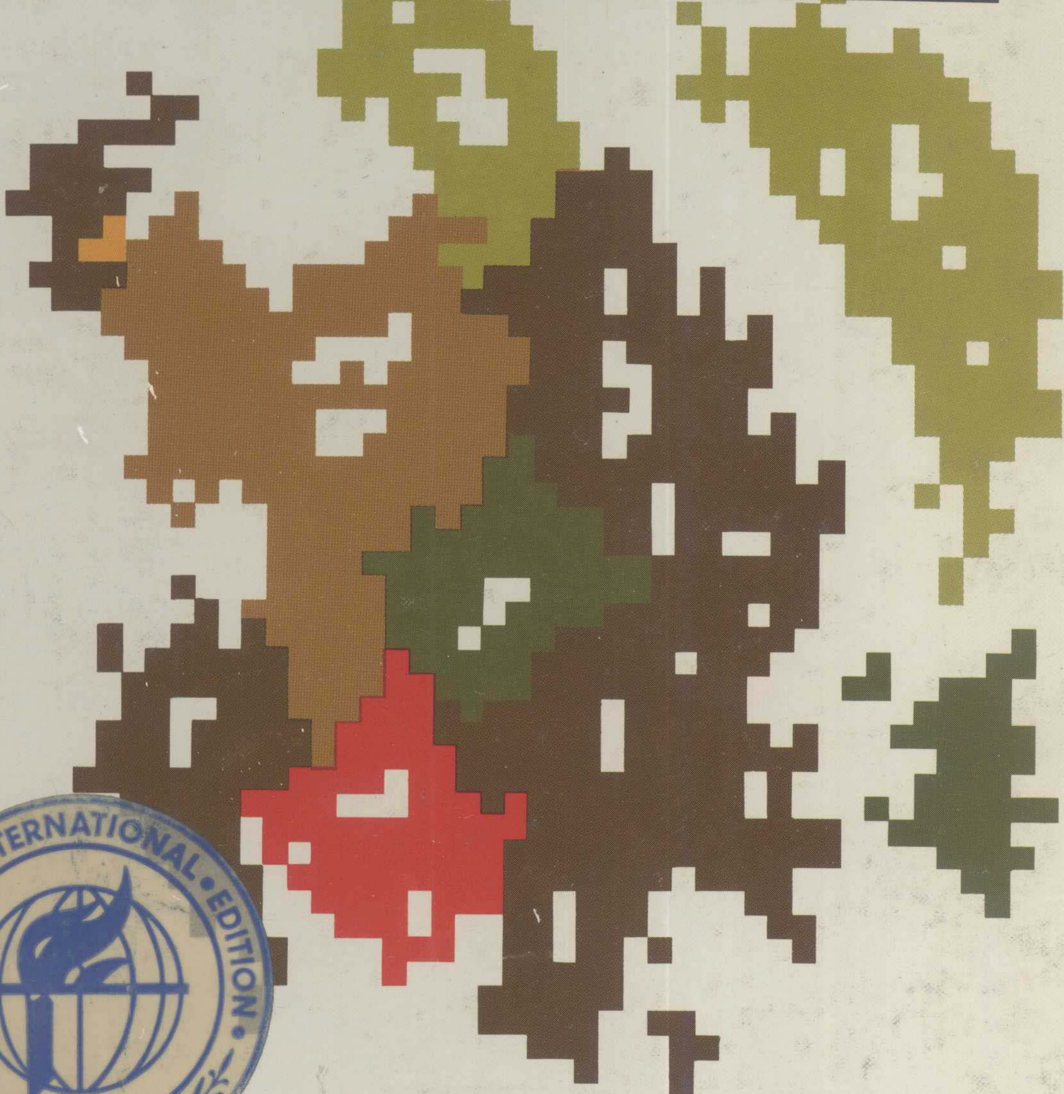
Intermediate Microeconomic Analysis

A. Myrick Freeman III



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BOWDOIN COLLEGE

1817

HARPER & ROW, PUBLISHERS, New York
Cambridge, Philadelphia, San Francisco,
London, Mexico City, São Paulo, Sydney

Sponsoring Editor: David Forgione
Project Editor: Eleanor Castellano
Designer: T. R. Funderburk
Manager of New Book Production: Kewal K. Sharma
Compositor: ComCom Division of Haddon Craftsmen, Inc.
Printer and Binder: R. R. Donnelley & Sons Company
Art Studio: Vantage Art, Inc.

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Library of Congress Cataloging in Publication Data

Freeman, A. Myrick, 1936–
Intermediate microeconomic analysis.

Includes index.
1. Microeconomics. I. Title.
HB172.F73 1983 338.5 82–25856
ISBN 0–06–042185–1

Intermediate Microeconomic Analysis

Preface

There are four key features of this book that I believe make it different from and better than other microeconomic texts and in combination will make it attractive to teachers of the intermediate micro course.

First, *Intermediate Microeconomic Analysis* emphasizes economic reasoning as a process for deriving testable hypotheses about economic behavior and empirically relevant behavioral relationships such as demand and supply functions. The method employed for deriving these relationships is comparative statics.

Second, throughout the book there is continuing discussion of the normative analysis of the outcomes of economic processes, especially the proposition that perfect competition leads to Pareto optimality. The topics considered include the concept of consumer surplus as a basis for measuring changes in individual welfare, economic efficiency, the social cost of monopoly, and the normative implications of marginal productivity theory. There is also an extensive discussion of efficiency and equity in the two chapters on welfare economics.

Third, I show that microeconomics is not just about prices and market equilibria, but also about how societies deal with their resource allocation problems in general. In order to emphasize this point, I have followed a different set of organizing principles from those governing most current textbooks. In Chapters 3 to 5 I have introduced just enough production theory and preference theory to derive the production box, the production possibilities curve, and the exchange box for a two-person, two-good, two-factor economy. This model makes it possible to describe the three tasks that any economic system must accomplish: determining what to produce, how to produce it, and who gets the output. This discussion of the resource allocation problem is general in that there is no reference to any specific form of economic institution.

Next, I examine economic efficiency as a basis for evaluating alternative resource allocations, the nature of shadow prices and their role in achieving an efficient allocation, and the market system as an institution for translating shadow prices into market signals to guide the economic choices of individuals and firms. After the stage has been set and the economic problem posed in this way, I then consider preference and demand theory, production and cost theory, perfect competition, factor prices, monopoly, and so forth.

My experience in teaching intermediate microeconomics by following this organization has been successful. The early chapters provide a context within which the students can deal with the specifics of demand theory, production theory, and so forth. And they have a clearer picture of the basic normative issues concerning efficiency and equity as they come across topics such as consumer sovereignty, consumer surplus, perfect competition, and market power.

However, in view of the fact that not all instructors may care to follow this order of the material, I have provided alternative syllabi for utilizing this text for teaching a more conventionally organized course. These syllabi are presented after this Preface.

The fourth key feature of this text is an effort to draw some of the major connections between microeconomic analysis and macroeconomics. Specifically, the chapter on capital and the interest rate includes a model of individual savings behavior in which the choice between saving and consumption today is shown to be a function of the interest rate and income. The simple Keynesian consumption function is shown as a special case of this model in which the substitution and income effects of an interest rate change cancel out. And the positive marginal propensity to save out of current income follows from the fact that future consumption is a normal good. Second, the demand for funds to pursue investment projects is shown to depend not only on the interest rate but also upon expectations about the future monetary returns from investment. The Keynesian theory emphasizes the variability of these expectations. Finally there is a discussion of unemployment in the context of a model of the market for labor in which the wage rate serves to equate the quantity demanded and the quantity supplied.

In organizing and writing this book, I have tried to convey the idea that microeconomics is not just a set of analytical techniques and theorems. Rather, it is a valuable way of achieving a better understanding of the functioning of modern capitalist economies. Microeconomics also provides a way of analyzing economic problems in a variety of other economic institutional settings, for example, planning and resource allocation problems in socialist economies, resource allocation to the public sector, and so forth.

I have also raised several issues that are not always treated in conventional microeconomics texts. These issues include the question of how individual preferences are formed and influenced and the implications of preference modification for the positive and normative analysis of demand; the nature of the firm, the reasons for its existence, and alternative views concerning the behavior of the firm as an economic institution; the role of property rights and transactions costs in market economies; and the normative implications of the marginal productivity theory of factor prices.

The exposition in this book is primarily verbal and graphical. I have resorted to simple algebra in explaining some relationships such as the individual's budget constraint and as a shorthand notation for expressing behavioral relationships such as demand and supply functions. Short mathematical appendixes to many of the chapters show the use of the calculus in deriving some of the principal relationships and hypotheses. These appendixes are optional.

My thanks go to those individuals who helped me during the preparation of this book, especially my editor, John Greenman, and several colleagues, for their valuable advice; Richard K. Hay, who read a preliminary version of the manuscript and made significant suggestions; and Richard Dye, Peter Gottschalk, Robert Haveman, and Philip Sorenson, for their comments on parts of the manuscript. The great effort and care given by Jini Linkovich in typing the manuscript through several drafts are much appreciated.

A. MYRICK FREEMAN, III

Georgetown, Maine
December 1982

Alternative Course Syllabi

A key feature of this book is the presentation of the general problem of resource allocation and distribution in a two-person, two-good, two-factor economy before the detailed treatment of demand, production, competition, and so forth. I recognize that many instructors will prefer to retain the conventional organization of the material in which the general equilibrium model is introduced at the end of the course primarily as a basis for the analysis of Pareto optimality and welfare economics. For this reason, I have also prepared alternative sequences of reading assignments for those who wish to follow the conventional organization with either demand theory first or, as some instructors prefer, production theory first. The book has been written so that either alternative sequence can be followed without serious loss of continuity.

CONVENTIONAL ORGANIZATION WITH DEMAND THEORY FIRST

Introduction

Chapter 1. What Is Economics?
Chapter 2. Some Analytical Concepts
Chapter 6. Markets and Exchange

Competitive Markets

Chapter 4, Preferences, section on "Preference Orderings" (an introduction to indifference curves)
Chapter 7. Preferences and Demand
Chapter 8. Market Demand; Topics
Chapter 3, Production, section on "The Production Function" (an introduction to isoquants)

Chapter 9. The Firm and Production
Chapter 10. Cost
Chapter 11. Prices and Outputs in Competition
Chapter 12. Marginal Productivity and Factor Prices
Chapter 13. Capital

Market Power
Chapter 15. Monopoly
Chapter 16. Oligopoly and Monopolistic Competition

General Equilibrium and Welfare
Chapter 3, Production, sections on "Production with Two Goods" and "The Production Possibilities Frontier"
Chapter 4, Preferences, section on "A Simple Two-Person Economy"
Chapter 5. Economic Efficiency
Chapter 14. The General Equilibrium of a Competitive Economy
Chapter 17. Competition and Efficiency
Chapter 18. Equity and Social Welfare

CONVENTIONAL ORGANIZATION WITH PRODUCTION THEORY FIRST

Introduction
Chapter 1. What Is Economics?
Chapter 2. Some Analytical Concepts
Chapter 6. Markets and Exchange

Competitive Markets
Chapter 3, Production, section on "The Production Function" (an introduction to isoquants)
Chapter 9. The Firm and Production
Chapter 4, Preferences, section on "Preference Orderings" (an introduction to indifference curves)
Chapter 7. Preferences and Demand
Chapter 8. Market Demand; Topics
Chapter 10. Cost
Chapter 11. Prices and Outputs in Competition
Chapter 12. Marginal Productivity and Factor Prices
Chapter 13. Capital

Market Power
Chapter 15. Monopoly
Chapter 16. Oligopoly and Monopolistic Competition

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Chapter 4, Preferences, section on "A Simple Two-Person Economy"
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PART I
Introduction