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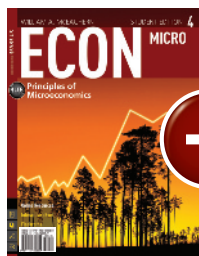
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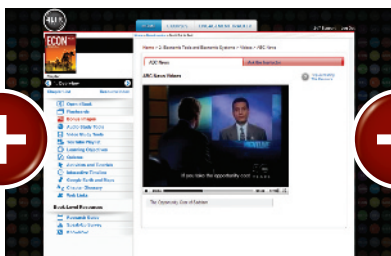
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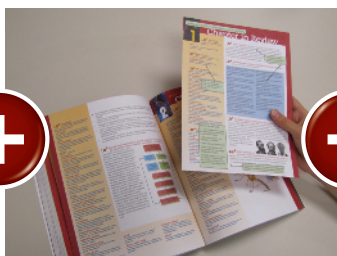
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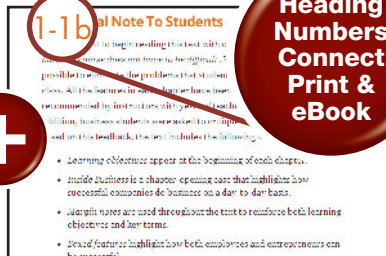
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Brief Contents



PART 1 Introduction to Economics

- 1** The Art and Science of Economic Analysis **2**
- 2** Economic Tools and Economic Systems **22**
- 3** Economic Decision Makers **36**
- 4** Demand, Supply, and Markets **52**

PART 2 Introduction to the Market System

- 5** Elasticity of Demand and Supply **70**
- 6** Consumer Choice and Demand **84**
- 7** Production and Cost in the Firm **96**

PART 3 Market Structure and Pricing

- 8** Perfect Competition **110**
- 9** Monopoly **130**
- 10** Monopolistic Competition and Oligopoly **146**

PART 4 Resource Markets

- 11** Resource Markets **164**
- 12** Labor Markets and Labor Unions **178**
- 13** Capital, Interest, Entrepreneurship, and Corporate Finance **196**
- 14** Transaction Costs, Imperfect Information, and Behavioral Economics **214**

PART 5 Market Failure and Public Policy

- 15** Economic Regulation and Antitrust Policy **230**
- 16** Public Goods and Public Choice **246**
- 17** Externalities and the Environment **262**
- 18** Income Distribution and Poverty **280**

PART 6 International Economics

- 19** International Trade **300**
- 20** International Finance **318**
- 21** Economic Development **332**

Problems Appendix 351

Index 369

Contents

PART 1 Introduction to Economics

1 The Art and Science of Economic Analysis 2

1-1 The Economic Problem: Scarce Resources, Unlimited Wants 4

1-1a Resources 4 1-1b Goods and Services 5
1-1c Economic Decision Makers 6 1-1d A Simple Circular-Flow Model 6

1-2 The Art of Economic Analysis 7

1-2a Rational Self-Interest 7 1-2b Choice Requires Time and Information 8 1-2c Economic Analysis Is Marginal Analysis 8 1-2d Microeconomics and Macroeconomics 9

1-3 The Science of Economic Analysis 10

1-3a The Role of Theory 10 1-3b The Scientific Method 10 1-3c Normative Versus Positive 12 1-3d Economists Tell Stories 12 1-3e Predicting Average Behavior 13

1-4 Some Pitfalls of Faulty Economic Analysis 13

1-5 If Economists Are So Smart, Why Aren't They Rich? 14

1-6 Final Word 16



Appendix 17

A1-1 Understanding Graphs 17

A1-1a Drawing Graphs 18 A1-1b The Slope of a Straight Line 19 A1-1c The Slope, Units of Measurement, and Marginal Analysis 20 A1-1d The Slopes of Curved Lines 20 A1-1e Line Shifts 21

2 Economic Tools and Economic Systems 22

2-1 Choice and Opportunity Cost 23

2-1a Opportunity Cost 24 2-1b Opportunity Cost Is Subjective 24 2-1c Sunk Cost and Choice 25

2-2 Comparative Advantage, Specialization, and Exchange 25

2-2a The Law of Comparative Advantage 26 2-2b Absolute Advantage Versus Comparative Advantage 26 2-2c Specialization and Exchange 27 2-2d Division of Labor and Gains From Specialization 28

2-3 The Economy's Production Possibilities 28

2-3a Efficiency and the Production Possibilities Frontier or PPF 29 2-3b Inefficient and Unattainable Production 29

2-3d What Can Shift the Production Possibilities Frontier? 30

2-3c The Shape of the Production Possibilities Frontier 30
2-3e What We Learn From the PPF 32

2-4 Economic Systems 32

2-4a Three Questions Every Economic System Must Answer 32 2-4b Pure Capitalism 33 2-4c Pure Command System 34 2-4d Mixed and Transitional Economies 34 2-4e Economies Based on Custom or Religion 35

2-5 Final Word 35



3 Economic Decision Makers 36

3-1 The Household 37

3-1a The Evolution of the Household 38

3-1b Households Maximize Utility 38 3-1c Households As Resource Suppliers 38 3-1d Households As Demanders of Goods and Services 39

3-2 The Firm 39

3-2a The Evolution of the Firm 40 3-2b Types of Firms 40 3-2c Cooperatives 42 3-2d Not-for-Profit Organizations 43 3-2e Why Does Household Production Still Exist? 43

3-3 The Government 44

3-3a The Role of Government 44 3-3b Government's Structure and Objectives 46 3-3c The Size and Growth of Government 46 3-3d Sources of Government Revenue 47 3-3e Tax Principles and Tax Incidence 47

3-4 The Rest of the World 49

3-4a International Trade 49 3-4b Exchange Rates 50 3-4c Trade Restrictions 50

3-5 Final Word 50



4 Demand, Supply, and Markets 52

4-1 Demand 53

4-1a The Law of Demand 54 4-1b The Demand Schedule and Demand Curve 55

4-2 Shifts of the Demand Curve 56

4-2a Changes in Consumer Income 57 4-2b Changes in the Prices of Other Goods 57 4-2c Changes in Consumer Expectations 58 4-2d Changes in the Number or Composition of Consumers 58 4-2e Changes in Consumer Tastes 58

4-3 Supply 58

4-3a The Supply Schedule and Supply Curve 59

4-4 Shifts of the Supply Curve 60

4-4a Changes in Technology 60 4-4b Changes in the Prices of Resources 60 4-4c Changes in the Prices of Other Goods 60 4-4d Changes in Producer Expectations 61 4-4e Changes in the Number of Producers 61

4-5 Demand and Supply Create a Market 61

4-5a Markets 61 4-5b Market Equilibrium 62

4-6 Changes in Equilibrium Price and Quantity 63

4-6a Shifts of the Demand Curve 63 4-6b Shifts of the Supply Curve 64 4-6c Simultaneous Shifts of Demand and Supply Curves 65

4-7 Disequilibrium 66

4-7a Price Floors 66 4-7b Price Ceilings 66

4-8 Final Word 67

5 Elasticity of Demand and Supply 70

5-1 Price Elasticity of Demand 72

5-1a Calculating Price Elasticity of Demand 72

5-1b Categories of Price Elasticity of Demand 73

5-1c Elasticity and Total Revenue 73 5-1d Price Elasticity and the Linear Demand Curve 74 5-1e Constant-Elasticity Demand Curves 75

5-2 Determinants of the Price Elasticity of Demand 76

5-2a Availability of Substitutes 76 5-2b Share of the Consumer's Budget Spent on the Good 77

5-2c Duration of Adjustment Period 78

5-2d Elasticity Estimates 78

5-3 Price Elasticity of Supply 79

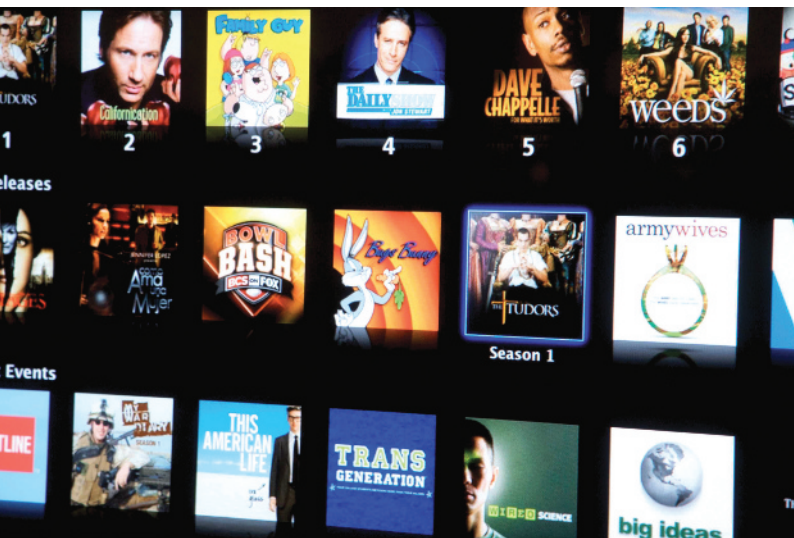
5-3a Constant Elasticity Supply Curves 80

5-3b Determinants of Supply Elasticity 81

5-4 Other Elasticity Measures 81

5-4a Income Elasticity of Demand 81 5-4b Cross-Price Elasticity of Demand 82

5-5 Final Word 83



6 Consumer Choice and Demand 84

6-1 Utility Analysis 85

6-1a Tastes and Preferences 86 6-1b The Law of Diminishing Marginal Utility 86

6-2 Measuring Utility 87

6-2a Units of Utility 87 6-2b Utility Maximization in a World Without Scarcity 88 6-2c Utility Maximization in a World of Scarcity 88 6-2d Utility-Maximizing Conditions 89 6-2e Marginal Utility and the Law of Demand 90

6-3 Applications of Utility Analysis 91

6-3a YOUR Consumer Surplus 91 6-3b Market Demand and Consumer Surplus 93 6-3c The Role of Time in Demand 94 6-4 Final Word 94



7 Production and Cost in the Firm 96

7-1 Cost and Profit 97

7-1a Explicit and Implicit Costs 98 7-1b Alternative Measures of Profit 98

7-2 Production in the Short Run 99

7-2a Fixed and Variable Resources 99 7-2b The Law of Diminishing Marginal Returns 100 7-2c The Total and Marginal Product Curves 101

7-3 Costs in the Short Run 101

7-3a Total Cost and Marginal Cost in

the Short Run 102 7-3b Average Cost in the Short Run 104 7-3c The Relationship Between Marginal Cost and Average Cost 104

7-4 Costs in the Long Run 105

7-4a Economies of Scale 106 7-4b Diseconomies of Scale 106 7-4c The Long-Run Average Cost Curve 107

7-4d Economies and Diseconomies of Scale at the Firm Level 108

7-5 Final Word 109

PART 3 Market Structure and Pricing



8 Perfect Competition 110

8-1 An Introduction to Perfect Competition 112

8-1a Perfectly Competitive Market Structure 112
8-1b Demand Under Perfect Competition 112

8-2 Short-Run Profit Maximization 113

8-2a Total Revenue Minus Total Cost 113
8-2b Marginal Revenue Equals Marginal Cost 115
8-2c Economic Profit in the Short Run 116

8-3 Minimizing Short-Run Losses 116

8-3a Fixed Cost and Minimizing Losses 116
8-3b Marginal Revenue Equals Marginal Cost 117
8-3c Shutting Down in the Short Run 118

8-4 The Firm and Industry Short-Run Supply Curves 119

8-4a The Short-Run Firm Supply Curve 119
8-4b The Short-Run Industry Supply Curve 120
8-4c Firm Supply and Market Equilibrium 120

8-5 Perfect Competition in the Long Run 121

8-5a Zero Economic Profit in the Long Run 122 8-5b The Long-Run Adjustment to a Change of Demand 122

8-6 The Long-Run Industry Supply Curve 124

8-6a Constant-Cost Industries 124 8-6b Increasing-Cost Industries 125

8-7 Perfect Competition and Efficiency 126

8-7a Productive Efficiency: Making Stuff Right 126 8-7b Allocative Efficiency: Making the Right Stuff 127 8-7c What's so Perfect About Perfect Competition? 127

8-8 Final Word 129



9 Monopoly 130

9-1 Barriers to Entry 132

9-1a Legal Restrictions 132 9-1b Economies of Scale 132 9-1c Control of Essential Resources 133

9-2 Revenue for a Monopolist 134

9-2a Demand, Average Revenue, and Marginal Revenue 134 9-2b The Gain and Loss From Selling One More Unit 134 9-2c Revenue Schedules 135 9-2d Revenue Curves 135

9-3 The Monopolist's Costs and Profit Maximization 135

9-3a Profit Maximization 136 9-3b Short-Run Losses and the Shutdown Decision 138 9-3c Long-Run Profit Maximization 139

9-4 Monopoly and the Allocation of Resources 140

9-4a Price and Output Under Perfect Competition 140 9-4b Price and Output Under Monopoly 140 9-4c Allocative and Distributive Effects 141

9-5 Problems Estimating the Deadweight Loss of Monopoly 141

9-5a Why the Deadweight Loss of Monopoly Might Be Lower 141 9-5b Why the Deadweight Loss Might Be Higher 141

9-6 Price Discrimination 142

9-6a Conditions for Price Discrimination 142 9-6b A Model of Price Discrimination 143 9-6c Examples of Price Discrimination 143 9-6d Perfect Price Discrimination: The Monopolist's Dream 144

9-7 Final Word 145

10 Monopolistic Competition and Oligopoly 146

10-1 Monopolistic Competition 148

10-1a Product Differentiation 148 10-1b Short-Run Profit Maximization or Loss Minimization 149 10-1c Zero Economic Profit in the Long Run 150 10-1d Monopolistic Competition and Perfect Competition Compared 151

10-2 Oligopoly 153

10-2a Varieties of Oligopoly 153 10-2b Economies of Scale 153 10-2c The High Cost of Entry 154 10-2d Crowding Out the Competition 154

10-3 Three Approaches to Oligopoly 155

10-3a Collusion and Cartels 155 10-3b Price Leadership 157 10-3c Game Theory 158

10-4 Comparison of Oligopoly and Perfect Competition 162

10-4a Price Is Usually Higher Under Oligopoly 162 10-4b Higher Profits Under Oligopoly 162

10-5 Final Word 162



PART 4 Resource Markets



11 Resource Markets 164

11-1 The Once-Over 166

11-1a Resource Demand 166 11-1b Resource Supply 166

11-2 The Demand and Supply of Resources 166

11-2a The Market Demand for Resources 167 11-2b The Market Supply of Resources 168

11-3 Temporary and Permanent Resource Price Differences 168

11-3a Temporary Differences in Resource Prices 168

11-3b Permanent Differences in Resource Prices 169

11-4 Opportunity Cost and Economic Rent 170

11-4a Resource Market A: All Earnings are Economic Rent 170

11-4b Resource Market B: All Earnings are Opportunity Cost 170 11-4c Resource Market C: Earnings Include Both Economic Rent and Opportunity Cost 171

11-5 A Closer Look at Resource Demand 172

11-5a The Firm's Demand for a Resource 172 11-5b Marginal Revenue Product 173 11-5c Marginal Resource Cost 174

11-5d Resource Employment to Maximize Profit or Minimize Loss 175 11-5e Optimal Input and Optimal Output Decisions are Equivalent 175 11-5f Changes in Resource Demand 175

11-5g The Optimal Use of More Than One Resource 177

11-6 Final Word 177

12 Labor Markets and Labor Unions 178

12-1 Labor Supply 180

12-1a Labor Supply and Utility Maximization 180

12-1b Wages and Individual Labor Supply 181

12-1c Nonwage Determinants of Labor Supply 183

12-1d Market Supply of Labor 184

12-2 Why Wages Differ 185

12-2a Differences in Training, Education, Age, and Experience 186 12-2b Differences in Ability 187

12-2c Differences in Risk 187 12-2d Geographic Differences 187

12-2e Discrimination 187

12-3 Unions and Collective Bargaining 187

12-3a Types of Unions 188 12-3b Collective Bargaining, Mediation, and Arbitration 188

12-3c The Strike 188

12-4 Union Wages and Employment 189

12-4a Inclusive, or Industrial, Unions: Negotiating a Higher Industry Wage 189 12-4b Exclusive, or Craft, Unions: Reducing Labor Supply 191

12-4c Increasing Demand for Union Labor 191 12-4d Trends in Union Membership 192

12-5 Final Word 194



13 Capital, Interest, Entrepreneurship, and Corporate Finance **196**

13-1 The Role of Time in Production and Consumption **198**

- 13-1a** Production, Saving, and Time 198
- 13-1b** Consumption, Saving, and Time 198
- 13-1c** Optimal Investment 199

13-2 The Market for Loanable Funds **201**

- 13-2a** Demand for Loanable Funds 202
- 13-2b** Supply of Loanable Funds 202
- 13-2c** Market Interest Rate 203

13-3 Why Interest Rates Differ **203**

- 13-3a** Risk 203
- 13-3b** Duration of the Loan 204
- 13-3c** Administration Costs 204
- 13-3d** Tax Treatment 204

13-4 Present Value and Discounting **204**

- 13-4a** Present Value of Payment One Year Hence 205
- 13-4b** Present Value for Payments in Later Years 205
- 13-4c** Present Value of an Income Stream 206
- 13-4d** Present Value of an Annuity 206

13-5 Entrepreneurship **206**

- 13-5a** Role of the Entrepreneur 206
- 13-5b** Entrepreneurs Drive the Economy Forward 207
- 13-5c** Who Are Not Entrepreneurs? 208

13-6 Corporate Finance **209**

- 13-6a** Corporate Stock and Retained Earnings 209
- 13-6b** Corporate Bonds 210
- 13-6c** Securities Exchanges 211

13-7 Final Word **212**



14 Transaction Costs, Imperfect Information, and Behavioral Economics **214**

14-1 Rationale for the Firm and its Scope of Operation **216**

- 14-1a** The Firm Reduces Transaction Costs 216
- 14-1b** The Boundaries of the Firm 217
- 14-1c** Economies of Scope 219

14-2 Market Behavior With Imperfect Information **220**

- 14-2a** Optimal Search With Imperfect Information 220
- 14-2b** The Winner's Curse 222

14-3 Asymmetric Information in Product Markets **222**

- 14-3a** Hidden Characteristics: Adverse Selection 223
- 14-3b** Hidden Actions: The Principal-Agent Problem 223
- 14-3c** Asymmetric Information in Insurance Markets 224
- 14-3d** Coping With Asymmetric Information 225

14-4 Asymmetric Information in Labor Markets **225**

- 14-4a** Adverse Selection in Labor Markets 226
- 14-4b** Signaling and Screening 226

14-5 Behavioral Economics **227**

- 14-5a** Unbounded Rationality 227
- 14-5b** Unbounded Willpower 228
- 14-5c** Neuroeconomics 228

14-6 Final Word **229**

15 Economic Regulation and Antitrust Policy 230

- 15-1** Types of Government Regulation 232
- 15-2** Regulating a Natural Monopoly 232
 - 15-2a** Unregulated Profit Maximization 232
 - 15-2b** Setting Price Equal to Marginal Cost 233
 - 15-2c** Subsidizing the Natural Monopolist 234
 - 15-2d** Setting Price Equal to Average Cost 234
 - 15-2e** The Regulatory Dilemma 234
- 15-3** Alternative Theories of Economic Regulation 234
 - 15-3a** Special Interests, Economic Regulation, and Deregulation 235
- 15-4** Antitrust Law and Enforcement 236
 - 15-4a** Origins of Antitrust Policy 236
 - 15-4b** Antitrust Enforcement 237
 - 15-4c** Per Se Illegality and the Rule of Reason 237
 - 15-4d** Mergers and Public Policy 238
 - 15-4e** Merger Waves 239
- 15-5** Competitive Trends in the U.S. Economy 240
 - 15-5a** Competition Over Time 240
 - 15-5b** Recent Competitive Trends 242
 - 15-5c** Problems With Antitrust Policy 242
- 15-6** Final Word 244



16 Public Goods and Public Choice 246

- 16-1** Public Goods 248
 - 16-1a** Private Goods, Public Goods, and in Between 248
 - 16-1b** Optimal Provision of Public Goods 249
 - 16-1c** Paying for Public Goods 250
- 16-2** Public Choice in Representative Democracy 250
 - 16-2a** Median-Voter Model 251
 - 16-2b** Special Interest and Rational Ignorance 251
 - 16-2c** Distribution of Benefits and Costs 252
- 16-3** Exploiting Government Versus Avoiding Government 255
 - 16-3a** Rent Seeking 255
 - 16-3b** The Underground Economy 257
- 16-4** Bureaucracy and Representative Democracy 257
 - 16-4a** Ownership and Funding of Bureaus 258
 - 16-4b** Ownership and Organizational Behavior 258
 - 16-4c** Bureaucratic Objectives 259
 - 16-4d** Private Versus Public Production 259
- 16-5** Final Word 260

17 Externalities and the Environment 262

17-1 Externalities and the Common-Pool Problem 264

17-1a Renewable Resources 264 17-1b Resolving the Common-Pool Problem 265

17-2 Optimal Level of Pollution 266

17-2a External Costs with Fixed Technology 266 17-2b External Costs with Variable Technology 267 17-2c The Coase Theorem 269 17-2d Markets for Pollution Rights 269 17-2e Pollution Rights and Public Choice 271

17-3 Environmental Protection 272

17-3a Air Pollution 272 17-3b Water Pollution 273 17-3c Hazardous Waste and the Superfund 274 17-3d Solid Waste: "Paper or Plastic?" 275

17-4 Positive Externalities 277

17-5 Final Word 279



18 Income Distribution and Poverty 280

18-1 The Distribution of Household Income 282

18-1a Income Distribution by Quintiles 282 18-1b The Lorenz Curve 283 18-1c Why Incomes Differ 283 18-1d A College Education Pays More 284 18-1e Problems with Distribution Benchmarks 285

18-2 Redistribution Programs 286

18-2a Official Poverty Level 286 18-2b Programs to Help the Poor 286

18-3 Who Are the Poor? 290

18-3a Poverty and Age 290 18-3b Poverty and Public Choice 290 18-3c The Feminization of Poverty 291 18-3d Poverty and Discrimination 293 18-3e Affirmative Action 294

18-4 Unintended Consequences of Income Assistance 295

18-5 Welfare Reforms 296

18-5a Recent Reforms 296 18-5b Welfare Rolls Have Declined 297

18-6 Final Word 298



19 International Trade **300**

19-1 The Gains From Trade **302**

19-1a A Profile of Exports and Imports 302

19-1b Production Possibilities without Trade 303

19-1c Consumption Possibilities Based on Comparative Advantage 304 **19-1d** Reasons for International Specialization 306

19-2 Trade Restrictions and Welfare Loss **307**

19-2a Consumer Surplus and Producer Surplus From Market Exchange 308

19-2b Tariffs 308 **19-2c** Import Quotas 309 **19-2d** Quotas in Practice 311

19-2e Tariffs and Quotas Compared 311 **19-2f** Other Trade Restrictions 311

19-3 Efforts to Reduce Trade Barriers **311**

19-3a Freer Trade by Multilateral Agreement 312

19-3b The World Trade Organization 312 **19-3c** Common Markets 312

19-4 Arguments for Trade Restrictions **313**

19-4a National Defense Argument 313

19-4b Infant Industry Argument 314

19-4c Antidumping Argument 314 **19-4d** Jobs and Income Argument 314

19-4e Declining Industries Argument 315 **19-4f** Problems with Trade Protection 316

19-5 Final Word **316**

20 International Finance **318**

20-1 Balance of Payments **320**

20-1a International Economic Transactions 320

20-1b The Merchandise Trade Balance 320 **20-1c** Balance on Goods and Services 321

20-1d Net Investment Income 322

20-1e Unilateral Transfers and the Current Account Balance 322

20-1f The Financial Account 323 **20-1g** Deficits and Surpluses 323

20-2 Foreign Exchange Rates and Markets **324**

20-2a Foreign Exchange 324

20-2b The Demand for Foreign Exchange 325

20-2c The Supply of Foreign Exchange 326

20-2d Determining the Exchange Rate 326

20-3 Other Factors Influencing Foreign Exchange Markets **327**

20-3a Arbitrageurs and Speculators 327

20-3b Purchasing Power Parity 328

20-3c Flexible Exchange Rates 328

20-3d Fixed Exchange Rates 329

20-4 Development of the International Monetary System **329**

20-4a The Bretton Woods Agreement 330

20-4b The Demise of the Bretton Woods System 330 **20-4c** The Current System: Managed Float 331

20-5 Final Word **331**



21 Economic Development 332

21-1 Worlds Apart 334

21-1a Developing and Industrial Economies 334 **21-1b** Health and Nutrition 335 **21-1c** High Birth Rates 336
21-1d Women in Developing Countries 338

21-2 Productivity: Key to Development 338

21-2a Low Labor Productivity 338
21-2b Technology and Education 338
21-2c Inefficient Use of Labor 339
21-2d Natural Resources 339
21-2e Financial Institutions 340
21-2f Capital Infrastructure 340
21-2g Entrepreneurship 340 **21-2h** Rules of the Game 342 **21-2i** Income Distribution Within Countries 344

21-3 International Trade and Development 344

21-3a Trade Problems for Developing Countries 344 **21-3b** Migration and the Brain Drain 344 **21-3c** Import Substitution Versus Export Promotion 345
21-3d Trade Liberalization and Special Interests 345

21-4 Foreign Aid and Economic Development 346

21-4a Foreign Aid 346 **21-4b** Does Foreign Aid Promote Economic Development? 347 **21-4c** Do Economies Converge? 348

21-5 Final Word 348



The Art and Science

of Economic Analysis



Learning Outcomes

- 1-1 Explain the economic problem of scarce resources and unlimited wants
- 1-2 Describe the forces that shape economic choices
- 1-3 Explain the relationship between economic theory and economic reality
- 1-4 Identify some pitfalls of economic analysis
- 1-5 Describe several reasons to study economics

“Why are comic-strip and TV characters like those in *Foxtrot*, *The Simpsons*, and *Family Guy* missing a finger on each hand?”

Why are comic-strip and TV characters like those in *Foxtrot*, *The Simpsons*, and *Family Guy* missing a finger on each hand? Why do the kids on *South Park* have hands that look like mittens? And where is *Dilbert's* mouth? Which college majors pay the most right after college and during mid-career? In what way are people who pound on vending machines relying on theory? Why is a good theory like a California Closet? What's the big idea with economics?

What do you think?

Economics is a science, not an art.

Strongly Disagree

Strongly Agree

1 2 3 4 5 6 7

Finally, how can it be said that in economics “what goes around comes around”? These and other questions are answered in this chapter, which introduces the art and science of economic analysis.

You have been reading and hearing about economic issues for years—unemployment, inflation, poverty, recessions, federal deficits, college tuition, airfares, stock prices, computer prices, gas prices. When explanations of such issues go into any depth, your eyes may glaze over and you may tune out, the same way you do when a weather forecaster tries to provide an in-depth analysis of high-pressure fronts colliding with moisture carried in from the coast.

What many people fail to realize is that economics is livelier than the dry accounts offered by the news media. Economics is about making choices, and you make economic choices every day—choices about whether to get a part-time job or focus on your studies, live in a dorm or off campus, take a course in accounting or one in history, get married or stay single, pack a lunch or buy a sandwich. You already know much more about economics than you realize. You bring to the subject a rich personal experience, an experience that will be tapped throughout the book to reinforce your understanding of the basic ideas.

Topics discussed in Chapter 1 include

- The economic problem
- Marginal analysis
- Rational self-interest
- Scientific method
- Normative versus positive analysis
- Pitfalls of economic thinking

1-1 The Economic Problem: Scarce Resources, Unlimited Wants

Would you like a new car, a nicer home, better meals, more free time, a more interesting social life, more spending money, more leisure, more sleep? Who wouldn't? But even if you can satisfy some of these desires, others keep popping up. *The problem is that although your wants, or desires, are virtually unlimited, the resources available to satisfy these wants are scarce.* A resource is scarce when it is not freely available—that is, when its price exceeds zero. Because resources are scarce, you must choose from among your many

economics

The study of how people use their scarce resources to satisfy their unlimited wants

resources

The inputs, or factors of production, used to produce the goods and services that people want; resources consist of labor, capital, natural resources, and entrepreneurial ability

labor

The physical and mental effort used to produce goods and services

capital

The buildings, equipment, and human skills used to produce goods and services

natural resources

All gifts of nature used to produce goods and services; includes renewable and exhaustible resources

entrepreneurial ability

The imagination required to develop a new product or process, the skill needed to organize production, and the willingness to take the risk of profit or loss

entrepreneur

A profit-seeking decision maker who starts with an idea, organizes an enterprise to bring that idea to life, and assumes the risk of the operation

wants, and whenever you choose, you must forgo satisfying some other wants. The problem of scarce resources but unlimited wants exists to a greater or lesser extent for each of the 7 billion people on earth. Everybody—cab driver, farmer, brain surgeon, dictator, shepherd, student, politician—faces the problem. For example, a cab driver uses time and other scarce resources, such as the taxi, knowledge of the city, driving skills, and gasoline, to earn income. That income, in turn, buys housing, groceries, clothing, trips to Disney World, and thousands of other goods and services that help satisfy some of the driver's unlimited wants. **Economics** examines how people use their scarce resources to satisfy their unlimited wants. Let's pick apart the definition, beginning with resources, then goods and services, and finally focus on the heart of the matter—economic choice, which results from scarcity.

1-1a Resources

Resources are the inputs, or factors of production, used to produce the goods and services that people want. *Goods and services are scarce*

because resources are scarce. Resources sort into four broad categories: labor, capital, natural resources, and entrepreneurial ability. **Labor** is human effort, both physical and mental. Labor includes the effort of the cab driver and the brain surgeon. Labor itself comes from a more fundamental resource: *time*. Without time we can accomplish nothing. We allocate our time to alternative uses: We can *sell* our time as labor, or we can *spend* our time doing other things, like sleeping, eating, studying, playing sports, going online, attending class, watching TV, or just relaxing with friends.

Capital includes all human creations used to produce goods and services. Economists often distinguish between physical capital and human capital. *Physical capital* consists of factories, tools, machines, computers, buildings, airports, highways, and other human creations used to produce goods and services. Physical capital includes the cab driver's taxi, the surgeon's scalpel, and the building where your economics class meets (or, if you are taking this course online, your computer and online connectors). *Human capital* consists of the knowledge and skill people acquire to increase their productivity, such as the cab driver's knowledge of city streets, the surgeon's knowledge of human anatomy, and your knowledge of economics.

Natural resources include all *gifts of nature*, such as bodies of water, trees, oil reserves, minerals, even animals. Natural resources can be divided into renewable resources and exhaustible resources. A *renewable resource* can be drawn on indefinitely if used conservatively. Thus, timber is a renewable resource if felled trees are replaced to regrow a steady supply. The air and rivers are renewable resources if they are allowed sufficient time to cleanse themselves of any pollutants. More generally, biological resources like fish, game, livestock, forests, rivers, groundwater, grasslands, and soil are renewable if managed properly. An *exhaustible resource*—such as oil or coal—does not renew itself and so is available in a limited amount. Once burned, each barrel of oil or ton of coal is gone forever. The world's oil and coal deposits are exhaustible.

A special kind of human skill called **entrepreneurial ability** is the talent required to dream up a new product or find a better way to produce an existing one. This special skill comes from an entrepreneur. An **entrepreneur** is a profit-seeking decision maker who starts with an idea, organizes an enterprise to bring that idea to life, and then assumes the risk of operation. An entrepreneur pays resource owners for the opportunity to employ their resources in the firm. Every firm in the world today, such as Ford, Microsoft, Google, and Facebook, began as an idea in the mind of an entrepreneur.

Resource owners are paid **wages** for their labor, **interest** for the use of their capital, and **rent** for the use of their natural resources. Entrepreneurial ability is rewarded by **profit**, which equals the *revenue* from items sold minus the cost of the resources employed to make those items. The word *profit* comes from the Latin *proficere*, which means “to benefit.” The entrepreneur benefits from what’s left over after paying other resource suppliers. Sometimes the entrepreneur suffers a loss. Resource earnings are usually based on the *time* these resources are employed. Resource payments therefore have a time dimension, as in a wage of \$10 *per hour*, interest of 6 percent *per year*, rent of \$600 *per month*, or profit of \$10,000 *per year*.

1-1b Goods and Services

Resources are combined in a variety of ways to produce goods and services. A farmer, a tractor, 50 acres of land, seeds, and fertilizer combine to grow the

good: corn. One hundred musicians, musical instruments, chairs, a conductor, a musical score, and a music hall combine to produce the service: Beethoven’s *Fifth Symphony*. Corn is a **good** because it is something you can see, feel, and touch; it requires scarce resources to produce; and it satisfies human wants. The book you are now holding, the chair you are sitting in, the clothes you are wearing, and your next meal are all goods. The performance of the *Fifth Symphony* is a **service** because it is intangible, yet it uses scarce resources to satisfy human wants. Lectures, movies, concerts, phone service, wireless connections, yoga lessons, dry cleaning, and haircuts are all services.

Because goods and services are produced using scarce resources, they are themselves scarce. A *good* or *service* is scarce if the amount people desire exceeds the amount available at a zero price. Because we cannot have all the goods and services we would like, we must continually choose among them. We must choose among more pleasant living quarters, better meals, nicer clothes, more reliable transportation, faster computers, and so on. Making choices in a world of **scarcity** means we must pass up some goods and services. Exhibit 1 shows the options of one individual facing scarcity. But not everything is scarce. In

fact, some things we would prefer to have

Exhibit 1

Scarcity Means You Must Choose among Options



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© JAMES WESTON/SHUTTERSTOCK.COM; © ELENA ELISSEVA/SHUTTERSTOCK.COM; © ZIMMYTWS/SHUTTERSTOCK.COM

- wages**
Payment to resource owners for their labor
- interest**
Payment to resource owners for the use of their capital
- rent**
Payment to resource owners for the use of their natural resources
- profit**
Reward for entrepreneurial ability; sales revenue minus resource cost
- good**
A tangible product used to satisfy human wants
- service**
An activity, or intangible product, used to satisfy human wants
- scarcity**
Occurs when the amount people desire exceeds the amount available at a zero price

less of. For example, we would prefer to have less garbage, less spam e-mail, and less pollution. Things we want none of even at a zero price are called *bads*, the opposite of goods.

A few goods and services seem *free* because the amount available at a zero price exceeds the amount people want. For example, air and seawater often seem free because we can breathe all the air we want and have all the seawater we can haul away. Yet, despite the old saying “The best things in life are free,” most goods and services are scarce, not free, and even those that appear to be free come with strings attached. For example, *clean* air and *clean* seawater have become scarce. *Goods and services that are truly free are not the subject matter of economics. Without scarcity, there would be no economic problem and no need for prices.*

Sometimes we mistakenly think of certain goods as free because they involve no apparent cost to us. Napkins seem to be free at Starbucks. Nobody stops you from taking a fistful. Supplying napkins, however, costs the company millions each year and prices reflect that cost. Some restaurants make special efforts to keep napkin use down—such as packing them tightly into the dispenser or making you ask for them. And Starbucks recently reduced the thickness of its napkins.

You may have heard the expression “There is no such thing as a free lunch.” There is no free lunch because all goods and services involve a cost to someone. The lunch may seem free to you, but it draws scarce resources away from the production of other goods and services, and whoever provides a free lunch often expects something in return. A Russian proverb makes a similar point but with a bit more bite: “The only place you find free cheese is in a mouse-trap.” Albert Einstein once observed, “Sometimes one

pays the most for things one gets for nothing.”

market

A set of arrangements by which buyers and sellers carry out exchange at mutually agreeable terms

product market

A market in which a good or service is bought and sold

resource market

A market in which a resource is bought and sold

circular-flow model

A diagram that traces the flow of resources, products, income, and revenue among economic decision makers

1-1c Economic Decision Makers

There are four types of decision makers in the economy: households, firms, governments, and the rest of the world. Their interaction determines how an economy’s resources are allocated. *Households* play the starring role. As consumers, households demand the goods and services produced. As resource owners, households

supply labor, capital, natural resources, and entrepreneurial ability to firms, governments, and the rest of the world. *Firms, governments, and the rest of the world* demand the resources that households supply and then use these resources to supply the goods and services that households demand. The rest of the world includes foreign households, foreign firms, and foreign governments that supply resources and products to U.S. markets and demand resources and products from U.S. markets.

Markets are the means by which buyers and sellers carry out exchange. By bringing together the two sides of exchange, markets determine price, quantity, and quality. Markets are often physical places, such as supermarkets, department stores, shopping malls, or yard sales. But markets also include other mechanisms by which buyers and sellers communicate, such as classified ads, radio and television ads, telephones, bulletin boards, online sites, and face-to-face bargaining. These market mechanisms provide information about the quantity, quality, and price of products offered for sale. Goods and services are bought and sold in **product markets**. Resources are bought and sold in **resource markets**. The most important resource market is the labor, or job, market. Think about your own experience looking for a job, and you’ll already have some idea of that market.

1-1d A Simple Circular-Flow Model

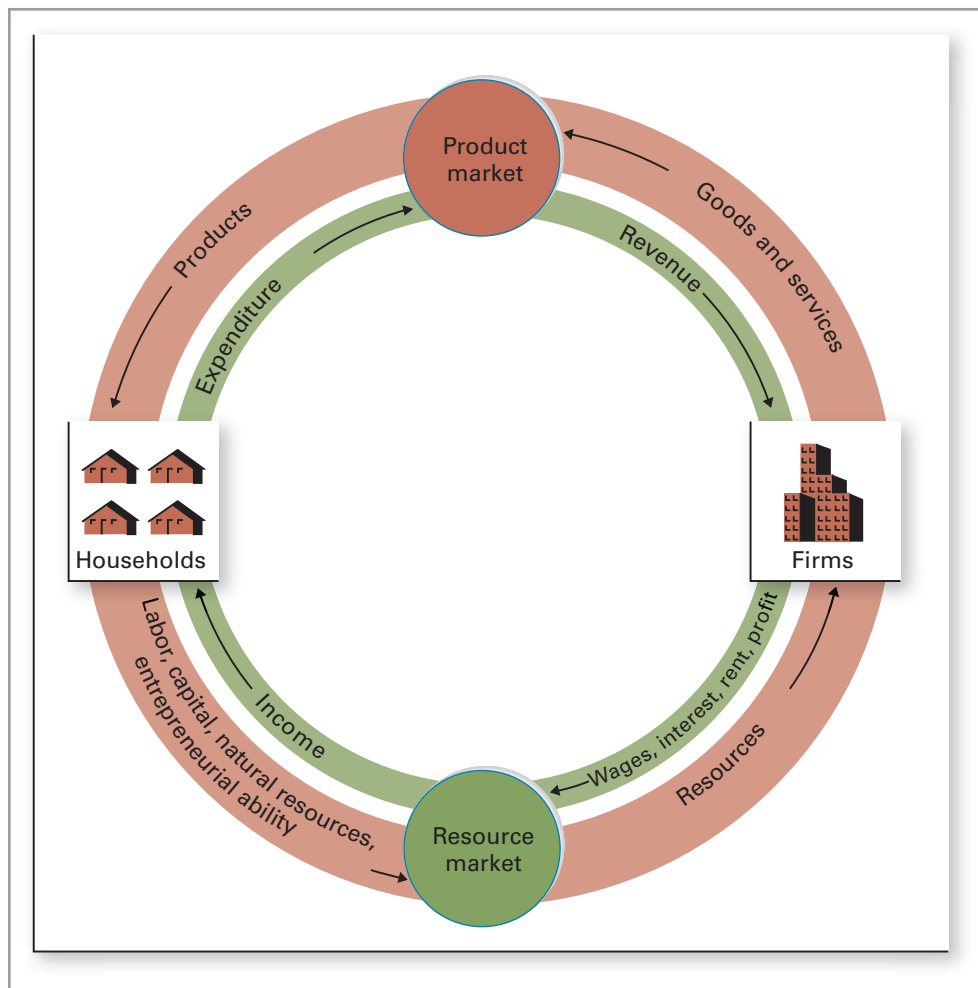
Now that you have learned a bit about economic decision makers, consider how they interact. Such a picture is conveyed by the **circular-flow model**, which describes the flow of resources, products, income, and revenue among economic decision makers. The simple circular-flow model focuses on the primary interaction in a market economy—that between households and firms. Exhibit 2 shows households on the left and firms on the right; please take a look.

Households supply labor, capital, natural resources, and entrepreneurial ability to firms through resource markets, shown in the lower portion of the exhibit. In return, households demand goods and services from firms through product markets, shown on the upper portion of the exhibit. Viewed from the business end, firms demand labor, capital, natural resources, and entrepreneurial ability from households through resource markets, and firms supply goods and services to households through product markets.

The flows of resources and products are supported by the flows of income and expenditure—that is, by the flow of money. So let’s add money. The demand and supply of resources come together in resource

Exhibit 2

The Simple Circular-Flow Model for Households and Firms



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problem—coping with scarce resources but unlimited wants—these choices deserve a closer look. Learning about the forces that shape economic choice is the first step toward mastering the art of economic analysis.

1-2a Rational Self-Interest

A key economic assumption is that individuals, in making choices, rationally select what they perceive to be in their best interests. By *rational*, economists mean simply that people try to make the best choices they can, given the available time and information. People may not know with certainty which alternative will turn out to be the best. They simply select the alternatives they expect will yield the most satisfaction and happiness. In general, **rational self-interest** means that each individual tries to maximize the expected

benefit achieved with a given cost or to minimize the expected cost of achieving a given benefit. Thus, economists begin with the assumption that people look out for their self-interest. For example, the USA Today weekly football poll asks coaches to list the top 25 teams in the country. It is no surprise that coaches distort their selections to favor their own teams and their own conferences. And, to make their own records look better, coaches inflate the rankings of teams they have beaten.¹

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rational self-interest

Each individual tries to maximize the expected benefit achieved with a given cost or to minimize the expected cost of achieving a given benefit

1-2 The Art of Economic Analysis

An economy results as millions of individuals attempt to satisfy their unlimited wants. Because their choices lie at the heart of the economic



1. Matthew Kotchen and Matthew Potoski, "Conflicts of Interest Distort Public Evaluations: Evidence from the Top 25 Ballots of NCAA Football Coaches," NBER Working Paper 17628 (November 2011).

Rational self-interest should not necessarily be viewed as blind materialism, pure selfishness, or greed. We all know people who are tuned to radio station WIIFM (What's In It For Me?). For most of us, however, self-interest often includes the welfare of our family, our friends, and perhaps the poor of the world. Even so, our concern for others is influenced by our personal cost of that concern. We may readily volunteer to drive a friend to the airport on Saturday afternoon but are less likely to offer a ride if the flight departs at 6:00 A.M. When we donate clothes to an organization such as Goodwill Industries, they are more likely to be old and worn than brand new. People tend to give more to charities when their contributions are tax deductible and when contributions garner social approval in the community (as when contributor names are made public or when big donors get buildings named after them).² TV stations are more likely to donate airtime for public-service announcements during the dead of night than during prime time (in fact, 80 percent of such announcements air between 11:00 P.M. and 7:00 A.M.). In Asia, some people burn money to soothe the passage of a departed loved one. But they burn fake money, not real money.

The notion of self-interest does not rule out concern for others; it simply means that concern for others is influenced by the same economic forces that affect other economic choices. *The lower the personal cost of helping others, the more help we offer.* We don't like to think that our behavior reflects our self-interest, but it usually does. As Jane Austen wrote in *Pride and Prejudice*, "I have been a selfish being all my life, in practice, though not in principle."

1-2b Choice Requires Time and Information

Rational choice takes time and requires information, but time and information are themselves scarce and therefore valuable. If you have any doubts about the time and information needed to make choices, talk to someone who recently purchased

"A key economic assumption is that individuals, in making choices, rationally select what they perceive to be in their best interest."

a home, a car, or a personal computer. Talk to a corporate official trying to decide whether to introduce a new product, sell online, build a new factory, or buy another firm. Or think back to your own experience in choosing a college. You probably

talked to friends, relatives, teachers, and guidance counselors. You likely used school catalogs, college guides, and Web sites. You may have even visited some campuses to meet the admissions staff and anyone else willing to talk. The decision took time and money, and it probably involved aggravation and anxiety.

Because information is costly to acquire, we are often willing to pay others to gather and digest it for us. College guidebooks, stock analysts, travel agents, real estate brokers, career counselors, restaurant critics, movie reviewers, specialized Web sites, and *Consumer Reports* magazine attest to our willingness to pay for information that improves our choices. As we'll see next, *rational decision makers continue to acquire information as long as the additional benefit expected from that information exceeds the additional cost of gathering it.*

1-2c Economic Analysis Is Marginal Analysis

Economic choice usually involves some adjustment to the existing situation, or status quo. Amazon.com must decide whether to add an additional line of products. The school superintendent must decide whether to hire another teacher. Your favorite jeans are on sale, and you must decide whether to buy another pair. You are wondering whether to carry an extra course next term. You just finished lunch and are deciding whether to order dessert.

Economic choice is based on a comparison of the *expected marginal benefit* and the *expected marginal cost* of the action under consideration. **Marginal** means incremental, additional, or extra. Marginal refers to a change in an economic variable, a change in the status quo. A *rational decision maker changes the status quo if the expected marginal benefit from the change exceeds the expected marginal cost.* For example, Amazon.com compares the marginal benefit expected from adding a new line of products (the additional sales revenue) with the marginal cost (the additional cost of the resources required). Likewise, you compare the marginal benefit you expect from eating dessert (the additional pleasure

marginal
Incremental, additional, or extra; used to describe a change in an economic variable



2. Dean Karlan and Margaret McConnell, "Hey Look at Me: The Effect of Giving Circles on Giving," NBER Working Paper 17737 (January 2012).



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or satisfaction) with its marginal cost (the additional money, time, and calories).

Typically, the change under consideration is small, but a marginal choice can involve a major economic adjustment, as in the decision to quit school and find a job. For a firm, a marginal choice might mean building a plant in Mexico or even filing for bankruptcy. By focusing on the effect of a marginal adjustment to the status quo, the economist is able to cut the analysis of economic choice down to a manageable size. Rather than confront a bewildering economic reality head-on, the economist begins with a marginal choice to see how this choice affects a particular market and shapes the economic system as a whole. Incidentally, to the noneconomist, *marginal* usually means relatively inferior, as in “a movie of marginal quality.” Forget that meaning for this course and instead think of *marginal* as meaning incremental, additional, or extra.

1-2d Microeconomics and Macroeconomics

Although you have made thousands of economic choices, you probably seldom think about your own economic behavior. For example, why are you reading this book right now rather than doing something else? **Microeconomics** is the study of your economic behavior and the economic behavior of others who make choices about such matters as how much to study and how much to party, how much to borrow and how much to save, what

to buy and what to sell. Microeconomics examines individual economic choices and how markets coordinate the choices of various decision makers. Microeconomics explains how price and quantity are determined in individual markets—the market for breakfast cereal, sports equipment, or used cars, for instance.

You have probably given little thought to what influences your own economic choices. You have likely given even less thought to how your choices link up with those made by millions of others in the U.S. economy to determine economy-wide measures such as total production, employment, and economic growth. **Macroeconomics** studies the performance of the economy as a whole. Whereas microeconomics studies the individual pieces of the economic puzzle, as reflected in particular markets, macroeconomics puts all the pieces together to focus on the big picture. Macroeconomics sees the forest, not the trees; the beach, not the grains of sand; and the Rose Bowl parade float, not the individual flowers.

The national economy usually grows over time, but along the way it sometimes stumbles, experiencing recessions in economic activity, as reflected by a decline in production, employment, and other aggregate measures. **Economic fluctuations** are the rise and fall of economic activity relative to the long-term growth trend of the economy. These fluctuations, or *business cycles*, vary in length and intensity, but they usually involve the entire nation and often other nations too. For example, the U.S. economy now produces more than four times as much as it did in 1960, despite experiencing eight recessions since then, including the Great Recession of 2007–2009.

To Review: The art of economic analysis focuses on how people use their scarce resources in an attempt to satisfy their unlimited wants. Rational self-interest guides individual choice. Choice requires time and information and involves a comparison of the expected marginal benefit and the expected marginal cost of alternative actions. Microeconomics looks at the individual pieces of the economic puzzle; macroeconomics fits the pieces together to form the big picture.

microeconomics

The study of the economic behavior in particular markets, such as that for computers or unskilled labor

macroeconomics

The study of the economic behavior of entire economies, as measured, for example, by total production and employment

economic fluctuations

The rise and fall of economic activity relative to the long-term growth trend of the economy; also called business cycles