

O'Sullivan | Sheffrin | Perez



MICROECONOMICS

Principles, Applications, and Tools

NINTH EDITION

Microeconomics

PRINCIPLES, APPLICATIONS, AND TOOLS

NINTH EDITION

Arthur O'Sullivan

Lewis and Clark College

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Tulane University

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Library of Congress Cataloging-in-Publication Data

O'Sullivan, Arthur.

Microeconomics : principles, applications, and tools / Arthur O'Sullivan, Lewis and Clark College, Steven M. Sheffrin, Tulane University, Stephen J. Perez, California State University, Sacramento. -- Ninth Edition.

pages cm

Revised edition of the authors' Microeconomics, 2014.

ISBN 978-0-13-407887-8

1. Microeconomics. I. Sheffrin, Steven M. II. Perez, Stephen J. III. Title.

HB172.O85 2015

338.5--dc23

2015034129

10 9 8 7 6 5 4 3 2 1

PEARSON

ISBN 10: 0-13-407887-X
ISBN 13: 978-0-13-407887-8

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Brief Contents

PART 1 Introduction and Key Principles

- 1 Introduction: What Is Economics? 1
- 2 The Key Principles of Economics 26
- 3 Exchange and Markets 45
- 4 Demand, Supply, and Market Equilibrium 60

PART 2 A Closer Look at Demand and Supply

- 5 Elasticity: A Measure of Responsiveness 89
- 6 Market Efficiency and Government Intervention 117
- 7 Consumer Choice: Utility Theory and Insights from Neuroscience 141

PART 3 Market Structures and Pricing

- 8 Production Technology and Cost 173
- 9 Perfect Competition 194
- 10 Monopoly and Price Discrimination 220

- 11 Market Entry and Monopolistic Competition 240

- 12 Oligopoly and Strategic Behavior 255

- 13 Controlling Market Power: Antitrust and Regulation 282

PART 4 Externalities and Information

- 14 Imperfect Information: Adverse Selection and Moral Hazard 296

- 15 Public Goods and Public Choice 320

- 16 External Costs and Environmental Policy 336

PART 5 The Labor Market and Income Distribution

- 17 The Labor Market and the Distribution of Income 358

PART 6 The International Economy

- 18 International Trade and Public Policy 383

Contents

Preface xv

PART 1 Introduction and Key Principles

1 Introduction: What Is Economics? 1

What Is Economics? 2

Positive versus Normative Analysis 3

The Three Key Economic Questions: What, How,
and Who? 4

Economic Models 4

Economic Analysis and Modern Problems 5

Economic View of Traffic Congestion 5

Economic View of Poverty in Africa 5

Economic View of the Current World Recession 6

The Economic Way of Thinking 6

Use Assumptions to Simplify 7

Isolate Variables—*Ceteris Paribus* 7

Think at the Margin 7

Rational People Respond to Incentives 8

APPLICATION 1 Incentives to Buy Hybrid Vehicles 8

Example: London Addresses Its Congestion
Problem 9

APPLICATION 2 Housing Prices in Cuba 9

Preview of Coming Attractions: Macroeconomics 10

Using Macroeconomics to Understand Why
Economies Grow 10

Using Macroeconomics to Understand Economic
Fluctuations 10

Using Macroeconomics to Make Informed
Business Decisions 11

Preview of Coming Attractions: Microeconomics 11

Using Microeconomics to Understand Markets
and Predict Changes 11

Using Microeconomics to Make Personal and
Managerial Decisions 11

Using Microeconomics to Evaluate Public
Policies 12

* SUMMARY 12 * KEY TERMS 12

* EXERCISES 13

APPENDIX: Using Graphs and Percentages 14

USING GRAPHS 14

COMPUTING PERCENTAGE CHANGES AND USING
EQUATIONS 22

APPLICATION 3 The Perils of Percentages 23

2 The Key Principles of Economics 26

The Principle of Opportunity Cost 27

The Cost of College 27

The Cost of Military Spending 28

Opportunity Cost and the Production Possibilities
Curve 28

APPLICATION 1 Don't Forget the Costs of Time and Invested Funds 30

The Marginal Principle 31

How Many Movie Sequels? 31

Renting College Facilities 32

Automobile Emissions Standards 33

Driving Speed and Safety 33

APPLICATION 2 How Fast to Sail? 34

The Principle of Voluntary Exchange 34

Exchange and Markets 34

Online Games and Market Exchange 35

APPLICATION 3 Rory McIlroy and Weed-Wacking 35

The Principle of Diminishing Returns 36

APPLICATION 4 Fertilizer and Crop Yields 37

The Real-Nominal Principle 37

The Design of Public Programs 38

The Value of the Minimum Wage 38

APPLICATION 5 Repaying Student Loans 39

* SUMMARY 39 * KEY TERMS 40

* EXERCISES 40

* ECONOMIC EXPERIMENT 44

3 Exchange and Markets 45

Comparative Advantage and Exchange 46

Specialization and the Gains from Trade 46

Comparative Advantage versus Absolute Advantage 48

The Division of Labor and Exchange 48

Comparative Advantage and International Trade 49

Outsourcing 49

APPLICATION 1 Absolute Disadvantage and Comparative Advantage in Latvia 50

Markets 51

Virtues of Markets 51

The Role of Entrepreneurs 52

Example of the Emergence of Markets: POW Camps 53

APPLICATION 2 The Market for Meteorites 53

Market Failure and the Role of Government 54

Government Enforces the Rules of Exchange 54

Government Can Reduce Economic Uncertainty 55

APPLICATION 3 Property Rights and Urban Slums 56

* SUMMARY 56 * KEY TERMS 56

* EXERCISES 57

4 Demand, Supply, and Market Equilibrium 60

The Demand Curve 61

The Individual Demand Curve and the Law of Demand 61

From Individual Demand to Market Demand 63

APPLICATION 1 The Law of Demand for Young Smokers 64

The Supply Curve 64

The Individual Supply Curve and the Law of Supply 65

Why Is the Individual Supply Curve Positively Sloped? 66

From Individual Supply to Market Supply 67

Why Is the Market Supply Curve Positively Sloped? 68

APPLICATION 2 Law of Supply and Woolympics 69

Market Equilibrium: Bringing Demand and Supply Together 69

Excess Demand Causes the Price to Rise 69

Excess Supply Causes the Price to Drop 70

APPLICATION 3 Shrinking Wine Lakes 71

Market Effects of Changes in Demand 71

Change in Quantity Demanded versus Change in Demand 71

Increases in Demand Shift the Demand Curve 72

Decreases in Demand Shift the Demand Curve 74

A Decrease in Demand Decreases the Equilibrium Price 75

APPLICATION 4 Chinese Demand and Pecan Prices 75

Market Effects of Changes in Supply 76

Change in Quantity Supplied versus Change in Supply 76

Increases in Supply Shift the Supply Curve 76

An Increase in Supply Decreases the Equilibrium Price 78

Decreases in Supply Shift the Supply Curve 79

A Decrease in Supply Increases the Equilibrium Price 79

Simultaneous Changes in Demand and Supply 80

APPLICATION 5 The Harmattan and the Price of Chocolate 82

Predicting and Explaining Market Changes 82

APPLICATION 6 Why Lower Drug Prices? 83

* SUMMARY 83 * KEY TERMS 84

* EXERCISES 84

* ECONOMIC EXPERIMENT 88

PART 2

A Closer Look at Demand and Supply

5 Elasticity: A Measure of Responsiveness 89

The Price Elasticity of Demand 90

Computing Percentage Changes and Elasticities 90

Price Elasticity and the Demand Curve 91

Elasticity and the Availability of Substitutes 93

Other Determinants of the Price Elasticity of Demand 94

APPLICATION 1 A Closer Look at the Elasticity of Demand for Gasoline 95

Using Price Elasticity 96

Predicting Changes in Quantity 96

Price Elasticity and Total Revenue 96

Using Elasticity to Predict the Revenue Effects of Price Changes 98

APPLICATION 2 Vanity Plates and the Elasticity of Demand 99

Elasticity and Total Revenue for a Linear Demand Curve 99

Price Elasticity along a Linear Demand Curve 99

APPLICATION 3 Drones and the Lower Half of a Linear Demand Curve 101

Elasticity and Total Revenue for a Linear Demand Curve 102

Other Elasticities of Demand 102

Income Elasticity of Demand 102

Cross-Price Elasticity of Demand 102

APPLICATION 4 I can Find that Elasticity in Four Clicks! 103

The Price Elasticity of Supply 104

What Determines the Price Elasticity of Supply? 105

The Role of Time: Short-Run versus Long-Run Supply Elasticity 105

Extreme Cases: Perfectly Inelastic Supply and Perfectly Elastic Supply 106

APPLICATION 5 The Short-Run and Long-Run Elasticity of Supply of Coffee 107

Predicting Changes in Quantity Supplied 107

Using Elasticities to Predict Changes in Prices 107

The Price Effects of a Change in Demand 107

The Price Effects of a Change in Supply 109

APPLICATION 6 A Broken Pipeline and the Price of Gasoline 111

* SUMMARY 111 * KEY TERMS 112

* EXERCISES 112

6 Market Efficiency and Government Intervention 117

Consumer Surplus and Producer Surplus 118

The Demand Curve and Consumer Surplus 119

The Supply Curve and Producer Surplus 120

APPLICATION 1 Consumer Surplus of Internet Service 121

Market Equilibrium and Efficiency 121

Total Surplus Is Lower with a Price below the Equilibrium Price 121

Total Surplus Is Lower with a Price above the Equilibrium Price 123

Efficiency and the Invisible Hand 123

Government Intervention in Efficient Markets 124

APPLICATION 2 Rent Control and Mismatches 124

Controlling Prices—Maximum and Minimum Prices 125

Setting Maximum Prices 125

Rent Control 125

APPLICATION 3 Price Controls and the Shrinking Candy Bar 127

Setting Minimum Prices 127

Controlling Quantities—Licensing and Import Restrictions 127

Taxi Medallions 128

Licensing and Market Efficiency 129

Winners and Losers from Licensing 129

Import Restrictions 129

APPLICATION 4 The Cost of Protecting a Lumber Job 131

Who Really Pays Taxes? 131

Tax Shifting: Forward and Backward 131

Tax Shifting and the Price Elasticity of Demand 132

Cigarette Taxes and Tobacco Land 133

The Luxury Boat Tax and Boat Workers 133

Tax Burden and Deadweight Loss 134

APPLICATION 5 Response to a Luxury Tax 135

* SUMMARY 136 * KEY TERMS 136

* EXERCISES 136

* ECONOMIC EXPERIMENT 140

7 Consumer Choice: Utility Theory and Insights from Neuroscience 141

Traditional Consumer Choice: Utility Theory 142

Consumer Constraints: The Budget Line 142

Total and Marginal Utility 144

The Marginal Principle and the Equimarginal Rule 145

Conditions for Utility Maximization 147

APPLICATION 1 Measuring Diminishing Marginal Utility 149

The Law of Demand and the Individual Demand Curve 149

Effect of a Decrease in Price 149

Income and Substitution Effects of a Decrease in Price 150

The Individual Demand Curve 152

The Neuroscience of Consumer Choice 152

APPLICATION 2 A Revenue-Neutral Gasoline Tax 153

The Neuroscience of Benefit Valuation 153

The Neuroscience of Cost Valuation 154

The Wisdom of Gut Feelings 155

Cognition and Choice 155

Predicting Consumer Choice 156

Fuel for Cognition 157

APPLICATION 3 Coke versus Pepsi in the Prefrontal Cortex 158

Consumer Decisions: Insights from Neuroscience 158

Dietary Choice: Donut versus Apple 158

Present Bias: Spending versus Saving 160

Present Bias and Credit Cards 161

Present Bias and Smoking 162

Gambling as a Consumer Good 162

APPLICATION 4 Taxing Cigarettes to Offset Present Bias 164

* SUMMARY 164 * EXERCISES 165

APPENDIX: Mental Shortcuts and Consumer Puzzles 169

MENTAL ACCOUNTING AND BUNDLING 169

ANCHORING 170

THE DECOY EFFECT 170

THE APPEAL OF PERCENTAGE CHANGES 171

* SUMMARY 172

PART 3

Market Structures and Pricing

8 Production Technology and Cost 173

Economic Cost and Economic Profit 174

APPLICATION 1 Opportunity Cost and Entrepreneurship 175

A Firm with a Fixed Production Facility: Short-Run Costs 175

Production and Marginal Product 175

Short-Run Total Cost 177

Short-Run Average Costs 178

Short-Run Marginal Cost 180

The Relationship between Marginal Cost and Average Cost 180

APPLICATION 2 The Rising Marginal Cost of Crude Oil 182

Production and Cost in the Long Run 182

Expansion and Replication 182

Reducing Output with Indivisible Inputs 184

Scaling Down and Labor Specialization 185

Economies of Scale 185

Diseconomies of Scale 185

Actual Long-Run Average-Cost Curves 186

Short-Run versus Long-Run Average Cost 187

APPLICATION 3 Indivisible Inputs and the Cost of Fake Killer Whales 187

Examples of Production Cost 188

Scale Economies in Wind Power 188

The Average Cost of a Music Video 188

Solar versus Nuclear: The Crossover 189

* SUMMARY 190 * KEY TERMS 190

* EXERCISES 191

9 Perfect Competition 194

Preview of the Four Market Structures 195

APPLICATION 1 Wireless Women in Pakistan 197

The Firm's Short-Run Output Decision 197

The Total Approach: Computing Total Revenue and Total Cost 198

The Marginal Approach 199

Economic Profit and the Break-Even Price 201

APPLICATION 2 The Break-Even Price for Switchgrass, a Feedstock For Biofuel 201

The Firm's Shut-Down Decision 202

Total Revenue, Variable Cost, and the Shut-Down Decision 202

The Shut-Down Price 203

Fixed Costs and Sunk Costs 204

APPLICATION 3 Straddling the Zinc Cost Curve 204

Short-Run Supply Curves 205

The Firm's Short-Run Supply Curve 205

The Short-Run Market Supply Curve 205

Market Equilibrium 206

APPLICATION 4 Short-Run Supply Curve for Cargo 207

The Long-Run Supply Curve for an Increasing-Cost Industry 207

Production Cost and Industry Size 208

Drawing the Long-Run Market Supply Curve 209

Examples of Increasing-Cost Industries: Sugar and Apartments 209

APPLICATION 5 Chinese Coffee Growers Obey the Law of Supply 210

Short-Run and Long-Run Effects of Changes in Demand 210

The Short-Run Response to an Increase in Demand 210

The Long-Run Response to an Increase in Demand 211

APPLICATION 6 The Upward Jump and Downward Slide of Blueberry Prices 212

Long-Run Supply for a Constant-Cost Industry 213

Long-Run Supply Curve for a Constant-Cost Industry 213

Hurricane Andrew and the Price of Ice 213

APPLICATION 7 Economic Detective and the Case of Margarine Prices 214

* SUMMARY 215 * KEY TERMS 215

* EXERCISES 215

10 Monopoly and Price Discrimination 220

The Monopolist's Output Decision 221

Total Revenue and Marginal Revenue 222

A Formula for Marginal Revenue 223

Using the Marginal Principle 224

APPLICATION 1 Marginal Revenue From a Baseball Fan 226

The Social Cost of Monopoly 227

Deadweight Loss from Monopoly 227

Rent Seeking: Using Resources to Get Monopoly Power 229

Monopoly and Public Policy 229

APPLICATION 2 Rent Seeking for Tribal Casinos 230

Patents and Monopoly Power 230

Incentives for Innovation 230

Trade-Offs from Patents 231

APPLICATION 3 Bribing the Makers of Generic Drugs 231

Price Discrimination 232

Senior Discounts in Restaurants 233

Price Discrimination and the Elasticity of Demand 234

Examples: Movie Admission versus Popcorn, and Hardback versus Paperback Books 234

APPLICATION 4 Why does Movie Popcorn Cost so Much? 235

* SUMMARY 235 * KEY TERMS 236

* EXERCISES 236

* ECONOMIC EXPERIMENT 239

11 Market Entry and Monopolistic Competition 240

The Effects of Market Entry 241

Entry Squeezes Profits from Three Sides 242

Examples of Entry: Car Stereos, Trucking, and Tires 243

APPLICATION 1 Satellite versus Cable 243

Monopolistic Competition 244

When Entry Stops: Long-Run Equilibrium 244

Differentiation by Location 245

APPLICATION 2 Opening a Motel 246

Trade-Offs with Entry and Monopolistic Competition 247

Average Cost and Variety 247

Monopolistic Competition versus Perfect Competition 247

APPLICATION 3 Happy Hour Pricing 248

Advertising for Product Differentiation 249

APPLICATION 4 Picture of Man versus Picture of Woman 249

* SUMMARY 251 * KEY TERMS 251

* EXERCISES 251

* ECONOMIC EXPERIMENT 253

12 Oligopoly and Strategic Behavior 255

Cartel Pricing and the Duopolists' Dilemma 257

Price Fixing and the Game Tree 258

Equilibrium of the Price-Fixing Game 260

Nash Equilibrium 261

APPLICATION 1 Failure of the Salt Cartel 262

Overcoming the Duopolists' Dilemma 262

Low-Price Guarantees 262

Repeated Pricing Games with Retaliation for Underpricing 263

Price Fixing and the Law 265

Price Leadership 265

APPLICATION 2 Low-Price Guarantee Increases Tire Prices 266

Simultaneous Decision Making and the Payoff Matrix 266

Simultaneous Price-Fixing Game 266

The Prisoners' Dilemma 267

APPLICATION 3 Cheating on the Final Exam: The Cheaters' Dilemma 268

The Insecure Monopolist and Entry Deterrence 269

Entry Deterrence and Limit Pricing 270

Examples: Aluminum and Campus Bookstores 271

Entry Deterrence and Contestable Markets 272

When Is the Passive Approach Better? 272

APPLICATION 4 Microsoft as an Insecure Monopolist 273

The Advertisers' Dilemma 273

APPLICATION 5 Got Milk? 275

* SUMMARY 276 * KEY TERMS 276

* EXERCISES 276

* ECONOMIC EXPERIMENT 281

13 Controlling Market Power: Antitrust and Regulation 282

Natural Monopoly 283

Picking an Output Level 283

Will a Second Firm Enter? 284

Price Controls for a Natural Monopoly 285

APPLICATION 1 Public versus Private Waterworks 286

APPLICATION 2 Satellite Radio as a Natural Monopoly 287

Antitrust Policy 287

Breaking Up Monopolies 288

Blocking Mergers 288

Merger Remedy for Wonder Bread 290

Regulating Business Practices 291

A Brief History of U.S. Antitrust Policy 291

APPLICATION 3 Merger of Pennzoil and Quaker State 292

APPLICATION 4 Merger of Office Depot and OfficeMax 292

* SUMMARY 293 * KEY TERMS 293

* EXERCISES 293

PART 4

Externalities and Information

14 Imperfect Information: Adverse Selection and Moral Hazard 296

Adverse Selection for Buyers: The Lemons Problem 297

Uninformed Buyers and Knowledgeable Sellers 297

Equilibrium with All Low-Quality Goods 298

A Thin Market: Equilibrium with Some High-Quality Goods 299

APPLICATION 1 Are Baseball Pitchers Like Used Cars? 301

Evidence of the Lemons Problem 301

Responding to the Lemons Problem 302

Buyers Invest in Information 302

Consumer Satisfaction Scores from ValueStar and eBay 302

Guarantees and Lemons Laws 303

APPLICATION 2 Regulation of the California Kiwifruit Market 303

Adverse Selection for Sellers: Insurance 304

Health Insurance 304

Equilibrium with All High-Cost Consumers 305

Responding to Adverse Selection in Insurance: Group Insurance 306

The Uninsured 306

Other Types of Insurance 307

APPLICATION 3 Genetic Discrimination 307

Insurance and Moral Hazard 308

Insurance Companies and Moral Hazard 308

Deposit Insurance for Savings and Loans 308

APPLICATION 4 Car Insurance and Risky Driving 309

The Economics of Consumer Search 309

Search and the Marginal Principle 310

Reservation Prices and Searching Strategy 311

The Effects of Opportunity Cost and Product Prices on Search Effort 313

APPLICATION 5 Income and Consumer Search 313

* SUMMARY 314 * KEY TERMS 314

* EXERCISES 314

* ECONOMIC EXPERIMENT 318

15 Public Goods and Public Choice 320

External Benefits and Public Goods 322

Public Goods and the Free-Rider Problem 323

Overcoming the Free-Rider Problem 323

APPLICATION 1 Clearing Space Debris 324

APPLICATION 2 Global Weather Observation 324

Private Goods with External Benefits 325

External Benefits from Education 325

External Benefits and the Marginal Principle 325

Other Private Goods That Generate External Benefits 326

APPLICATION 3 External Benefits from Lojack 327

APPLICATION 4 The Private and External Benefit of Trees 327

Public Choice and the Median Voter 327

Voting and the Median-Voter Rule 328

The Median Voter and the Median Location 329

Alternative Models of Government: Self-Interest and Special Interests 330

Which Theory Is Correct? 331

APPLICATION 5 The Median Voter in the NBA 331

* SUMMARY 332 * KEY TERMS 332

* EXERCISES 332

* ECONOMIC EXPERIMENT 334

16 External Costs and Environmental Policy 336

The Optimal Level of Pollution 337

Using the Marginal Principle 337

Example: The Optimal Level of Water Pollution 338

Coase Bargaining 339

APPLICATION 1 Reducing Methane Emissions 340

Taxing Pollution 341

A Firm's Response to a Pollution Tax 341

The Market Effects of a Pollution Tax 342

Example: A Carbon Tax 343

APPLICATION 2 Washing Carbon Out of the Air 344

Traditional Regulation 345

Uniform Abatement with Permits 345

Command and Control 345

Market Effects of Pollution Regulations 346

Lesson from Dear Abby: Options for Pollution Abatement 346

APPLICATION 3 Options for Reducing CO₂ Emissions From International Shipping 347

Marketable Pollution Permits 347

Voluntary Exchange and Marketable Permits 347

Supply, Demand, and the Price of Marketable Permits 348

APPLICATION 4 Weather and the Price of Pollution Permits 350

External Costs from Automobiles 350

External Costs from Pollution 350

External Costs from Congestion 352

External Costs from Collisions 352

APPLICATION 5 Young Drivers and Collisions 353

* SUMMARY 353 * KEY TERMS 354

* EXERCISES 354

* ECONOMIC EXPERIMENT 356

PART 5 The Labor Market and Income Distribution

17 The Labor Market and the Distribution of Income 358

The Demand for Labor 359

Labor Demand by an Individual Firm in the Short Run 359

Market Demand for Labor in the Short Run 361

Labor Demand in the Long Run 362

Short-Run versus Long-Run Demand 363

APPLICATION 1 Marginal Revenue Product in Major League Baseball 363

The Supply of Labor 364

The Individual Labor-Supply Decision: How Many Hours? 364

An Example of Income and Substitution Effects 364

The Market Supply Curve for Labor 365

APPLICATION 2 Cabbies Respond to an Increase in the Wage 366

Labor Market Equilibrium 366

- Changes in Demand and Supply 366
- The Market Effects of the Minimum Wage 367
- Why Do Wages Differ across Occupations? 368
- The Gender Pay Gap 369
- Racial Discrimination 370
- Why Do College Graduates Earn Higher Wages? 370
- Labor Unions and Wages 371

APPLICATION 3 The Beauty Premium 372**The Distribution of Income 372**

- Income Distribution in 2007 372
- Recent Changes in the Distribution of Income 373

APPLICATION 4 Trade-Offs From Immigration 374**Public Policy and the Distribution of Income 375**

- Effects of Tax and Transfer Policies on the Distribution of Income 375
- Poverty and Public Policy 376
- The Earned Income Tax Credit 377

APPLICATION 5 Expanding the EITC 378

- * SUMMARY 378 * KEY TERMS 379
- * EXERCISES 379

PART 6**The International Economy****18 International Trade and Public Policy 383****Benefits from Specialization and Trade 384**

- Production Possibilities Curve 384
- Comparative Advantage and the Terms of Trade 386

The Consumption Possibilities Curve 386

How Free Trade Affects Employment 387

Protectionist Policies 388

- Import Bans 388
- Quotas and Voluntary Export Restraints 389
- Responses to Protectionist Policies 390

APPLICATION 1 The Impact of Tariffs on the Poor 391**What Are the Rationales for Protectionist Policies? 391**

- To Shield Workers from Foreign Competition 392
- To Nurture Infant Industries until They Mature 392
- To Help Domestic Firms Establish Monopolies in World Markets 392

APPLICATION 2 Chinese Imports and Local Economies 393**A Brief History of International Tariff and Trade Agreements 393****Recent Policy Debates and Trade Agreements 394**

Are Foreign Producers Dumping Their Products? 394

APPLICATION 3 Does Losing in the WTO Really Matter? 395

Do Trade Laws Inhibit Environmental Protection? 396

APPLICATION 4 How American are American Cars? 397

Do Outsourcing and Trade Cause Income Inequality? 398

Why Do People Protest Free Trade? 399

- * SUMMARY 399 * KEY TERMS 400
- * EXERCISES 400

Glossary 403

Photo Credits 408

Index 409

Preface

In preparing this ninth edition, we had three primary goals. First, we wanted to incorporate the sweeping changes in the United States and world economies we have all witnessed in the last several years, and the difficulties that the world economies have continued to experience in recovering from the severe economic downturn. Second, we strived to update this edition to reflect the latest exciting developments in economic thinking and make these accessible to new students of economics. Finally, we wanted to stay true to the philosophy of the textbook—using basic concepts of economics to explain a wide variety of timely and interesting economic applications.

► WHAT'S NEW TO THIS EDITION

In addition to updating all the figures and data, we made a number of other key changes in this edition. They include the following:

- At the beginning of each chapter, we carefully refined our Learning Objectives to match the contents of the chapter closely. These give the students a preview of what they will learn in each section of the chapter, facilitating their learning.
- We incorporated a total of seven new chapter-opening stories. These chapter-opening stories show the widespread relevance of economic analysis.
- In the opening four chapters, the new Applications include housing prices in Cuba (Chapter 1), property rights in urban slums (Chapter 3), and the effects of winds from the Sahara Desert on the price of chocolate (Chapter 4).
- In the core microeconomics chapters, the new Applications include the market effects of a luxury tax (Chapter 6), the neuroscience of the “cola wars” between Coke and Pepsi (Chapter 7), the time path of blueberry prices triggered by publicity about the health benefits of eating blueberries (Chapter 9), the new advertising program for dairy products, “Milk Life” (Chapter 12), genetic discrimination in insurance (Chapter 14), clearing space debris (Chapter 15), responding to climate change by washing carbon out of the air (Chapter 16), and proposals to expand the earned income tax credit (Chapter 17).


▶ APPLYING THE CONCEPTS

This is an Applications-driven textbook. We carefully selected over 80 real-world Applications that help students develop and master essential economic concepts. Here is an example of our approach from Chapter 4, “Demand, Supply, and Market Equilibrium.”

Application 1

THE LAW OF DEMAND FOR YOUNG SMOKERS

APPLYING THE CONCEPTS #1: What is the law of demand?



As price decreases and we move downward along the market demand for cigarettes, the quantity of cigarettes demanded increases for two reasons. First, people who smoked cigarettes at the original price respond to the lower price by smoking more. Second, some people start smoking.

In the United States, cigarette taxes vary across states, and studies of cigarette consumption patterns show that higher taxes mean less cigarette consumption by youths. Using data from the Youth Risk Behavior Surveys (YRBS), one study shows

that increases in state cigarette taxes between 1990 and 2005 resulted in less participation (fewer smokers) and lower frequency (fewer cigarettes per smoker). A change in cigarette taxes in Canada illustrates the second effect, the new-smoker effect. In 1994, several provinces in eastern Canada cut their cigarette taxes in response to the smuggling of cigarettes from the United States (where taxes are lower), and the price of cigarettes in the provinces decreased by roughly 50 percent. Researchers tracked the choices of 591 youths from the Waterloo Smoking Prevention Program and concluded that the lower price increased the smoking rate by roughly 17 percent. **Related to Exercises 1.6 and 1.8.**

SOURCES: (1) Anindya Sen and Tony Wirjanto, “Estimating the Impacts of Cigarette Taxes on Youth Smoking Participation, Initiation, and Persistence: Empirical Evidence from Canada,” *Health Economics* 19 (2010), pp. 1264–1280. (2) Christopher Carpenters and Philip J. Cook, “Cigarette Taxes and Youth Smoking: New Evidence from National, State, and Local Youth Risk Behavior Surveys,” *Journal of Health Economics* 27 (2008), pp. 281–299.

Each chapter includes three to five thought-provoking Applying the Concepts questions that convey important economic concepts, paired with and illustrated by an Application that discusses the concept and conveys its real-world use.

For each Application and Applying the Concepts question, we provide end-of-chapter exercises that test students’ understanding of the concepts.

5.6 **Using Open-Economy Multipliers.** In an open economy, the marginal propensity to consume is 0.9, and the marginal propensity to import is 0.3. How much of an increase in investment would be necessary to raise GDP by 200? What would be your answer if this was a closed economy?

5.7 **Export-Led Growth Strategies.** Many countries believe that they need to increase exports in order to grow. Some of this belief is based on long-run considerations, as competing in export markets may induce their firms to innovate. But some countries also focus on the short-run benefits. What are these benefits? (Related to Application 4 on page 238.)

The Income-Expenditure Model and the Aggregate Demand Curve

Explain how the aggregate demand curve is related to the income-expenditure model.

6.1 An increase in the price level will _____ GDP and thereby move the economy _____ the aggregate demand curve.

6.2 At any price level, the income-expenditure model determines the level of equilibrium output and the corresponding point on the _____ curve.

6.3 An increase in the price level will not shift the aggregate demand curve. _____ (True/False)

ECONOMIC EXPERIMENT

ESTIMATING THE MARGINAL PROPENSITY TO CONSUME

For this experiment, each class member is asked to fill out the following table. Given a certain monthly income, how would you spend it and how much would you save? The top row of each column gives you the monthly disposable income. How would you allocate it each month among the various categories of spending in the table and savings? Complete each column in the table. The sum of your entries should equal your disposable income at the top of each column. After you have filled out the chart, compute the changes in your savings and total consumption as your income goes up. What is your marginal propensity to save (MPS)? What is your marginal propensity to consume (MPC) over your total expenditures? Graph your consumption function.

Monthly Disposable Income	\$1,250	\$1,500	\$1,750	\$2,0
Expenditures and savings				
Food				
Housing				
Transportation				
Medical				
Entertainment				
Other expenses				
Savings				

MyEconLab
For additional economic experiments, please visit www.myeconlab.com.

KEY TERMS

expectations of inflation, p. 326

expectations Phillips curve, p. 329

growth version of the quantity equation, p. 337

hyperinflation, p. 338

monetarists, p. 340

money illusion, p. 326

nominal wages, p. 326

quantity equation, p. 336

rational expectations, p. 330

real wages, p. 326

seignorage, p. 336

velocity of money, p. 336

EXERCISES

All problems are assignable in MyEconLab exercises that update with real-time data are marked with ■.

Money Growth, Inflation, and Interest Rates

Describe how an economy at full employment with inflation differs from one without inflation.

1.1 The expected real rate of interest is the nominal interest rate plus the expected inflation rate. _____ (True/False)

1.2 Countries with lower rates of money growth have _____ interest rates.

1.3 If the growth rate of money increases from 3 to 5 percent, initially interest rates will _____.

1.4 A firm that expects higher profits from higher prices but does not recognize its costs are increasing is suffering from _____.

1.5 **Nominal and Real Interest Rates.** In Japan in the 1990s interest rates were near zero on government bonds. Some economists said that it was still possible to stimulate investment by creating negative real interest rates. If nominal rates could not fall below zero, explain how real interest rates could be made negative. (Hint: Think about inflation.)

1.6 **Money Neutrality, Long-Run Inflation, and the Natural Rate.** Explain carefully the relationship between the concept of monetary neutrality and the idea that the natural rate is independent of the longrun inflation rate.

1.7 **Taxes, Inflation, and Interest Rates.** If a business borrows funds at 10 percent per year, the business has a 40 percent tax rate, and the annual inflation rate is 5 percent, what are the real after-tax costs of funds to the business? Similarly, if an investor receives a nominal return of 8 percent on a savings deposit, the tax rate is 30 percent, and the inflation rate is 6 percent, what is the after-tax rate of return?

1.8 **Examples of Money Illusion.** What do the following two quotes have in common?

a. “My wages are going up 5 percent a year. If only inflation weren’t 5 percent a year, I would be rich.”

b. “My bank is paying 10 percent a year, but the 8 percent inflation rate is just eating up all my real investment gains.”

Understanding the Expectations Phillips Curve: The Relationship between Unemployment and Inflation

Explain the relationship between inflation and unemployment in the short run and long run.

2.1 If inflation increases less than expected, the actual unemployment rate will be _____ (above/below) the natural rate.

2.2 James Tobin explained business cycles with rational expectations. _____ (True/False)

2.3 The increase in the fraction of young people in the labor force that occurred when the baby-boom generation came of working age tended to _____ (raise/lower) the natural rate of unemployment.

2.4 In the late 1980s, as unemployment fell below the natural rate, inflation _____.

2.5 **Targeting the Natural Rate of Unemployment?** Because the natural rate of unemployment is the economists’ notion of what constitutes “full employment,” it might seem logical for the Fed to use monetary policy to move unemployment toward its natural rate. However, many economists believe such a policy would be unwise because the natural rate may shift over time and policymakers may misjudge the correct rate. What would happen if the Fed targeted a 5 percent unemployment rate but the true natural rate were 6 percent?

2.6 **Hysteresis and the Labor Force Participation Rate.** In economics the term “hysteresis” means that the history of the economy has a lingering effect on current economic performance. During the U.S. recession starting in 2007, the labor force participation rate continued to remain below the levels that prevailed before the recession. Could this be an example of hysteresis? Can you suggest any other explanations?

2.7 **Oil Price Changes, Vacancies, and the Natural Rate.** During the mid-1970s, changes in oil prices required products to be produced by different types of firms in different locations. This raised the number of vacancies relative to the unemployment rate. According to the theory of William Dickens, how did this

341

In addition, some chapters contain an Economic Experiment section that gives students the opportunity to do their own economic analysis.

244

► WHY FIVE KEY PRINCIPLES?

In Chapter 2, “The Key Principles of Economics,” we introduce the following five key principles and then apply them throughout the book:

1. **The Principle of Opportunity Cost.** The opportunity cost of something is what you sacrifice to get it.
2. **The Marginal Principle.** Increase the level of an activity as long as its marginal benefit exceeds its marginal cost. Choose the level at which the marginal benefit equals the marginal cost.
3. **The Principle of Voluntary Exchange.** A voluntary exchange between two people makes both people better off.
4. **The Principle of Diminishing Returns.** If we increase one input while holding the other inputs fixed, output will increase, but at a decreasing rate.
5. **The Real-Nominal Principle.** What matters to people is the real value of money or income—its purchasing power—not the face value of money or income.

This approach of repeating five key principles gives students the big picture—the framework of economic reasoning. We make the key concepts unforgettable by using them repeatedly, illustrating them with intriguing examples, and giving students many opportunities to practice what they’ve learned. Throughout the text, economic concepts

are connected to the five key principles when the following callout is provided for each principle:

PRINCIPLE OF OPPORTUNITY COST

The opportunity cost of something is what you sacrifice to get it.



► HOW IS THE BOOK ORGANIZED?

Chapter 1, “Introduction: What Is Economics?” uses three current policy issues—traffic congestion, poverty in Africa, and Japan’s prolonged recession—to explain the economic way of thinking. Chapter 2, “The Key Principles of Economics,” introduces the five principles we return to throughout the book. Chapter 3, “Exchange and Markets,” is devoted entirely to exchange and trade. We discuss the fundamental rationale for exchange and introduce some of the institutions modern societies developed to facilitate trade.

Students need to have a solid understanding of demand and supply to be successful in the course. Many students have difficulty understanding movement along a curve versus shifts of a curve. To address this difficulty, we developed an innovative way to organize topics in Chapter 4, “Demand, Supply, and Market Equilibrium.” We examine the law of demand and changes in quantity demanded, the law of supply and changes in quantity supplied, and then the notion of market equilibrium. After students have a firm grasp of equilibrium concepts, we explore the effects of changes in demand and supply on equilibrium prices and quantities.

Summary of the Chapters

A course in microeconomics starts with the first four chapters of the book, which provide a foundation for more detailed study of individual decision making and markets.

Part 2, “A Closer Look at Demand and Supply,” (Chapters 5 through 7), provides a closer look at demand and supply, including elasticity, market efficiency, and consumer choice. Part 3, “Market Structures and Pricing” (Chapters 8 through 13), starts with a discussion of production and costs, setting the stage for an examination of alternative market structures, including the extremes



of perfect competition and monopoly, as well as the middle ground of monopolistic competition and oligopoly. Part 4, “Externalities and Information” (Chapters 14 through 17), discusses the circumstances under which markets break down, including imperfect information, public goods, and environmental degradation.

Part 5, “The Labor Market and Income Distribution” (Chapter 18), explores the economic forces that determine wages, and also examines recent changes in the distribution of income and the effects of government programs on the income distribution.

► MyEconLab®

Digital Features Located in MyEconLab

MyEconLab is a unique online course management, testing, and tutorial resource. It is included with the eText version of the book or as a supplement to the print book. Students and instructors will find the following online resources to accompany the ninth edition:

- **Concept Checks:** Each section of each learning objective concludes with an online Concept Check that contains one or two multiple choice, true/false, or fill-in questions. These checks act as “speed bumps” that encourage students to stop and check their understanding of fundamental terms and concepts before moving on to the next section. The goal of this digital resource is to help students assess their progress on a section-by-section basis, so they can be better prepared for homework, quizzes, and exams.
 - **Animations:** Graphs are the backbone of introductory economics, but many students struggle to understand and work with them. Many of the numbered figures in the text a supporting animated version online. The goal of this digital resource is to help students understand shifts in curves, movements along curves, and changes in equilibrium values. Having an animated version of a graph helps students who have difficulty interpreting the static version in the printed text. Graded practice exercises are included with the animations. Our experience is that many students benefit from this type of online learning.
 - **Graphs Updated with Real-Time Data from FRED:** Approximately 16 graphs are continuously updated online with the latest available data from FRED (Federal Reserve Economic Data), which is a comprehensive, up-to-date data set maintained by the Federal Reserve Bank of St. Louis.
- 
- Students can display a pop-up graph that shows new data plotted in the graph. The goal of this digital feature is to help students understand how to work with data and understand how including new data affects graphs.
- **Interactive Problems and Exercises Updated with Real-Time Data from FRED:** The end-of-chapter problems in select chapters include real-time data exercises  that use the latest data from FRED. The book contains several of these specially-selected exercises. The goal of this digital feature is to help students become familiar with this key data source, learn how to locate data, and develop skills in interpreting data.

► INTEGRATED SUPPLEMENTS

The authors and Pearson Education have worked together to integrate the text and media resources to make teaching and learning easier.

For the Instructor

Instructors can choose how much or how little time to spend setting up and using MyEconLab. Here is a snapshot of what instructors are saying about MyEconLab:

MyEconLab offers [students] a way to practice every week. They receive immediate feedback and a feeling of personal attention. As a result, my teaching has become more targeted and efficient.

—Kelly Blanchard, Purdue University

Students tell me that offering them MyEconLab is almost like offering them individual tutors.


—Jefferson Edwards, Cypress Fairbanks College

MyEconLab’s eText is great—particularly in that it helps offset the skyrocketing cost of textbooks. Naturally, students love that.

—Doug Gehrke,
Moraine Valley Community College

Each chapter contains two preloaded exercise sets that can be used to build an individualized study plan for each student. These study plan exercises contain tutorial resources, including instant feedback, links to the appropriate learning objective in the eText, pop-up definitions from the text, and step-by-step guided solutions, where appropriate. After the initial setup of the course by the instructor, student use of these materials requires no further instructor setup. The online grade book records each student’s performance and time spent on the tests and study plan and generates reports by student or chapter.

Instructors can fully customize MyEconLab to match their course exactly, including reading assignments, homework assignments, video assignments, current news assignments, and quizzes and tests. Assignable resources include:

- Preloaded exercise assignments sets for each chapter that include the student tutorial resources mentioned earlier
- Preloaded quizzes for each chapter that are unique to the text and not repeated in the study plan or homework exercise sets
- Study plan problems that are similar to the end-of-chapter problems and numbered exactly like the book to make assigning homework easier
- Real-Time-Data Analysis Exercises, marked with , allow students and instructors to use the very latest data from FRED. By completing the exercises, students become familiar with a key data source, learn how to locate data, and develop skills in interpreting data.
- In the eText available in MyEconLab, select figures labeled **MyEconLab Real-time data** allow students to display a pop-up graph updated with real-time data from FRED.

RTDA+: Measuring M2

Exercise Score: 0 of 1 pt Assignment Score: 0% (0 of 4 pts) 0 of 4 complete

Real-Time Data Analysis Exercise

Click the following link to view *M2 and Components* data from [FRED](#).
Then use that data to answer the following questions.

The following table contains, along with M1, the series IDs corresponding to the non-M1 components of M2, which are measured weekly and seasonally adjusted.

Complete this table by recording, for each series ID, the most recent observation (2014-05-05). (Enter your responses exactly as they appear in FRED.)

Series ID	Value
M1	\$2808.2 billion.
SAVINGS	\$ 7295.1 billion.
WRMFSL	\$ 637.9 billion.
WSMTIME	\$ 524.1 billion.

Using the data recorded above, the most recent observation of M2 is \$11,265.3 billion.

Enter your answer in the answer box, then click Check Answer.

2 parts remaining

Clear All Check Answer Save

*Real-time data provided by Federal Reserve Economic Data (FRED), Federal Reserve Bank of St. Louis.

- Current News Exercises provide a turnkey way to assign gradable news-based exercises in MyEconLab. Each week, Pearson scours the news, finds a current microeconomics and macroeconomics article, creates exercises around these news articles, and then automatically adds them to MyEconLab. Assigning and grading current news-based exercises that deal with the latest micro and macro events and policy issues has never been more convenient.
- Experiments in MyEconLab are a fun and engaging way to promote active learning and mastery of

important economic concepts. Pearson's Experiments program is flexible, easy-to-assign, auto-graded, and available in Single and Multiplayer versions.

- Single-player experiments allow your students to play against virtual players from anywhere at any time so long as they have an Internet connection.
- Multiplayer experiments allow you to assign and manage a real-time experiment with your class.
- Pre- and post-questions for each experiment are available for assignment in MyEconLab.

*Video: 5/9/14: Supply and demand Ex1

Exercise Score: 0 of 1 pt Assignment Score: 0% (0 of 9 pts) 0 of 9 complete

Why That Summer BBQ Will Cost More This Year

Source: Campbell, Elizabeth and Matt Miller - video report. "Why That Summer BBQ Will Cost More This Year." [Bloomberg.com](#), posted 5/9/2014.

Carefully watch the video, and then answer the following questions.

Graphically show the impact of a decrease in supply of pork on the price of pork.

- 1.) Using the *line drawing tool*, show the impact of a decrease in supply of pork on the price of pork. Properly label your curve.
- 2.) Using the *point drawing tool*, show the new equilibrium. Label your point 'E₂'.

Carefully follow the instructions above, and only draw the required objects.

Click a line or point to select it.

4 parts remaining

Clear All Check Answer Save

For a complete list of available experiments, visit <http://www.myeconlab.com>.

- Test Item File questions that allow you to assign quizzes or homework that will look just like your exams
- Econ Exercise Builder, which allows you to build customized exercises

Exercises include multiple-choice, graph drawing, and free-response items, many of which are generated algorithmically so that each time a student works them, a different variation is presented.

MyEconLab grades every problem type except essays, even problems with graphs. When working homework exercises, students receive immediate feedback, with links to additional learning tools.

Customization and Communication

MyEconLab in MyLab/Mastering provides additional optional customization and communication tools. Instructors who teach distance-learning courses or very large lecture sections find the MyLab/Mastering format useful because they can upload course documents and assignments, customize the order of chapters, and use communication features such as Document Sharing, Chat, ClassLive, and Discussion Board.

For the Student

MyEconLab puts students in control of their learning through a collection of testing, practice, and study tools tied to the online, interactive version of the textbook and other media resources. Here is a snapshot of what students are saying about MyEconLab:

It was very useful because it had EVERYTHING, from practice exams to exercises to reading. Very helpful.

—student, Northern Illinois University

I would recommend taking the quizzes on MyEconLab because it gives you a true account of whether or not you understand the material.

—student, Montana Tech

It made me look through the book to find answers, so I did more reading.

—student, Northern Illinois University

Students can study on their own or can complete assignments created by their instructor. In MyEconLab's structured environment, students practice what they learn, test their understanding, and pursue a personalized study plan generated from their performance on sample tests and from quizzes created by their instructors. In Homework or Study Plan mode, students have access to a wealth of tutorial features, including:

- Instant feedback on exercises that helps students understand and apply the concepts
- Links to the eText to promote reading of the text just when the student needs to revisit a concept or an explanation

- Step-by-step guided solutions that force students to break down a problem in much the same way an instructor would do during office hours
- Pop-up key term definitions from the eText to help students master the vocabulary of economics
- A graphing tool that is integrated into the various exercises to enable students to build and manipulate graphs to better understand how concepts, numbers, and graphs connect.

Additional MyEconLab Tools

MyEconLab includes the following additional features:

- **Enhanced eText**—Students actively read and learn, and with more engagement than ever before, through embedded and auto-graded practice, real-time data-graph updates, animations, author videos, and more.
- **Print upgrade**—For students who wish to complete assignments in MyEconLab but read in print, Pearson offers registered MyEconLab users a loose-leaf version of the print text at a significant discount.
- **Glossary flashcards**—Every key term is available as a flashcard, allowing students to quiz themselves on vocabulary from one or more chapters at a time.
- **MySearchLab**—MySearchLab provides extensive help on the research process and four exclusive databases of credible and reliable source material, including the *New York Times*, the *Financial Times*, and peer-reviewed journals.

MyEconLab content has been created through the efforts of Chris Annala, State University of New York–Geneseo; Charles Baum, Middle Tennessee State University; Peggy Dalton, Frostburg State University; Carol Dole, Jacksonville University; David Foti, Lone Star College; Sarah Ghosh, University of Scranton; Satyajit Ghosh, University of Scranton; Melissa Honig, Pearson Education; Woo Jung, University of Colorado; Courtney Kamauf, Pearson Education; Chris Kauffman, University of Tennessee–Knoxville; Russell Kellogg, University of Colorado–Denver; Noel Lotz, Pearson Education; Katherine McCann, University of Delaware; Daniel Mizak, Frostburg State University; Christine Polek, University of Massachusetts–Boston; Mark Scanlan, Stephen F. Austin State University; Leonie L. Stone, State University of New York–Geneseo; and Bert G. Wheeler, Cedarville University.

▶ OTHER RESOURCES FOR THE INSTRUCTOR

Instructor's Manuals

Jeff Phillips of Colby-Sawyer College revised the *Instructor's Manuals* for Microeconomics and Macroeconomics for the ninth edition. The *Instructor's Manuals* are designed to

help the instructor incorporate applicable elements of the supplement package. Each Instructor's Manual contains the following resources for each chapter:

- Chapter Summary: a bulleted list of key topics in the chapter
- Learning Objectives
- Approaching the Material; student-friendly examples to introduce the chapter
- Chapter Outline: summary of definitions and concepts
- Teaching Tips on how to encourage class participation
- Summary and discussion points for the Applications in the main text
- New Applications and discussion questions
- Solutions to all end-of-chapter exercises.

The *Instructor's Manuals* are available for download from the Instructor's Resource Center (<http://www.pearsonhighered.com/osullivan>). The solutions to the end-of-chapter review questions and problems were prepared by the authors and Jeff Phillips.

Two Test Item Files

Jeff Phillips of Colby-Sawyer College prepared the *Test Item Files* for Microeconomics and Macroeconomics. Each *Test Item File* includes approximately 6,000 multiple-choice, true/false, short-answer, and graphing questions. There are questions to support each key feature in the book. The *Test Item Files* are available for download from the Instructor's Resource Center (<http://www.pearsonhighered.com/osullivan>). Test questions are annotated with the following information:

- **Difficulty:** 1 for straight recall, 2 for some analysis, 3 for complex analysis
- **Type:** multiple-choice, true/false, short-answer, essay
- **Topic:** the term or concept the question supports
- **Learning outcome**
- **AACSB** (see description that follows)
- **Page number** in the text.

The Association to Advance Collegiate Schools of Business (AACSB) The Test Item File author has connected select questions to the general knowledge and skill guidelines found in the AACSB Assurance of Learning Standards.

What Is the AACSB? AACSB is a not-for-profit corporation of educational institutions, corporations, and other organizations devoted to the promotion and improvement of higher education in business administration and accounting. A collegiate institution offering degrees in business administration or accounting may volunteer for AACSB accreditation review. The AACSB makes initial accreditation decisions and conducts periodic reviews to promote

continuous quality improvement in management education. Pearson Education is a proud member of the AACSB and is pleased to provide advice to help you apply AACSB Assurance of Learning Standards.

What Are AACSB Assurance of Learning Standards?

One of the criteria for AACSB accreditation is the quality of curricula. Although no specific courses are required, the AACSB expects a curriculum to include learning experiences in the following categories of Assurance of Learning Standards:

- Written and Oral Communication
- Ethical Understanding and Reasoning
- Analytical Thinking Skills
- Information Technology
- Diverse and Multicultural Work
- Reflective Thinking
- Application of Knowledge.

Questions that test skills relevant to these standards are tagged with the appropriate standard. For example, a question testing the moral questions associated with externalities would receive the Ethical Understanding and Reasoning tag.

How Can Instructors Use the AACSB Tags? Tagged questions help you measure whether students are grasping the course content that aligns with the AACSB guidelines noted earlier. This in turn may suggest enrichment activities or other educational experiences to help students achieve these skills.

TestGen

The computerized TestGen package allows instructors to customize, save, and generate classroom tests. The test program permits instructors to edit, add, or delete questions from the Test Item Files; analyze test results; and organize a database of tests and student results. This software allows for extensive flexibility and ease of use. It provides many options for organizing and displaying tests, along with search and sort features. The software and the Test Item Files can be downloaded from the Instructor's Resource Center (<http://www.pearsonhighered.com/osullivan>).

PowerPoint Lecture Presentation

Two sets of PowerPoint slides, prepared by Brock Williams of Metropolitan Community College, are available:

1. A comprehensive set of PowerPoint slides can be used by instructors for class presentations or by students for lecture preview or review. These slides include all the graphs, tables, and equations in the textbook. Two versions are available—step-by-step mode, in which you can build graphs as you would on a blackboard, and automated mode, in which you use a single click

per slide. Instructors can download these PowerPoint presentations from the Instructor's Resource Center (<http://www.pearsonhighered.com/osullivan>).

2. A student version of the PowerPoint slides is available as .pdf files. This version allows students to print the slides and bring them to class for note taking. Instructors can download these PowerPoint presentations from the Instructor's Resource Center (<http://www.pearsonhighered.com/osullivan>).

Learning Catalytics™

Learning Catalytics is a “bring your own device” Web-based student engagement, assessment, and classroom intelligence system. This system generates classroom discussion, guides lectures, and promotes peer-to-peer learning with real-time analytics. Students can use any device to interact in the classroom, engage with content, and even draw and share graphs.

To learn more, ask your local Pearson representative or visit <https://www.learningcatalytics.com>.

Digital Interactives

Focused on a single core topic and organized in progressive levels, each interactive immerses students in an assignable and auto-graded activity. Digital Interactives are also engaging lecture tools for traditional, online, and hybrid courses, many incorporating real-time data, data displays, and analysis tools for rich classroom discussions.

▶ OTHER RESOURCES FOR THE STUDENT

In addition to MyEconLab, Pearson provides the following resources.

Dynamic Study Modules

With a focus on key topics, these modules work by continuously assessing student performance and activity in real time and, using data and analytics, provide personalized content to reinforce concepts that target each student's particular strengths and weaknesses.

PowerPoint Slides

For student use as a study aid or note-taking guide, PowerPoint slides, prepared by Brock Williams of Metropolitan Community College, can be downloaded from MyEconLab or the Instructor's Resource Center (<http://www.pearsonhighered.com/osullivan>) and made available to students. The slides include:

- All graphs, tables, and equations in the text
- Figures in step-by-step mode and automated modes, using a single click per graph curve
- End-of-chapter key terms with hyperlinks to relevant slides

▶ REVIEWERS OF PREVIOUS EDITIONS

A long road exists between the initial vision of an innovative principles text and the final product. Along our journey we participated in a structured process to reach our goal. We wish to acknowledge the assistance of the many people who participated in this process.

Alabama

Jim Payne, Calhoun Community College
James Swofford, University of South Alabama

Alaska

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William Hallagan, *Washington State University*
 Charles S. Wassell, Jr., *Central Washington University*
 Mark Wylie, *Spokane Falls Community College*

Australia

Hak Youn Kim, *Monash University*

► CLASS TESTERS

A special acknowledgment goes to the instructors who were willing to class-test drafts of early editions in different stages of development. They provided us with instant feedback on parts that worked and parts that needed changes:

Sheryl Ball, *Virginia Polytechnic Institute and State University*
 John Constantine, *University of California, Davis*
 John Farrell, *Oregon State University*
 James Hartley, *Mt. Holyoke College*
 Kailash Khandke, *Furman College*
 Peter Lindert, *University of California, Davis*
 Louis Makowski, *University of California, Davis*
 Barbara Ross-Pfeiffer, *Kapiolani Community College*

► FOCUS GROUPS

We want to thank the participants who took part in the focus groups for the first and second editions; they helped us see the manuscript from a fresh perspective:

Carlos Aquilar, *El Paso Community College*
 Jim Bradley, *University of South Carolina*
 Thomas Collum, *Northeastern Illinois University*

David Craig, *Westark College*
 Jeff Holt, *Tulsa Junior College*
 Thomas Jeitschko, *Texas A&M University*
 Gary Langer, *Roosevelt University*
 Mark McLeod, *Virginia Polytechnic Institute and State University*
 Tom McKinnon, *University of Arkansas*
 Amy Meyers, *Parkland Community College*
 Hassan Mohammadi, *Illinois State University*
 John Morgan, *College of Charleston*
 Norm Paul, *San Jacinto Community College*
 Nampeang Pingkaratwat, *Chicago State University*
 Scanlan Romer, *Delta Community College*
 Barbara Ross-Pfeiffer, *Kapiolani Community College*
 Zabra Saderion, *Houston Community College*
 Virginia Shingleton, *Valparaiso University*
 Jim Swofford, *University of South Alabama*
 Janet West, *University of Nebraska, Omaha*
 Linda Wilson, *University of Texas, Arlington*
 Michael Youngblood, *Rock Valley Community College*

► A WORLD OF THANKS . . .

We would also like to acknowledge the team of dedicated authors who contributed to the various ancillaries that accompany this book: Jeff Phillips of Colby-Sawyer College; Brian Rosario of California State University, Sacramento; and Brock Williams of Metropolitan Community College.

For the eighth edition, Liz Napolitano was the senior production project manager who worked with Michelle Gardner at SPi-Global to turn our manuscript pages into a beautiful published book. Lindsey Sloan, program manager, guided the project and coordinated the schedules for the book and the extensive supplement package that accompanies the book. David Alexander, executive acquisitions editor, supported us and our users during the life of this edition.

From the start, Pearson provided us with first-class support and advice. Over the first seven editions, many people contributed to the project, including Leah Jewell, Rod Banister, P. J. Boardman, Marie McHale, Gladys Soto, Lisa Amato, Victoria Anderson, Cynthia Regan, Kathleen McLellan, Sharon Koch, David Theisen, Steve Deitmer, Christopher Bath, Ben Paris, Elisa Adams, Jodi Bolognese, David Alexander, Virginia Guariglia, and Lynne Breitfeller.

Last but not least, we must thank our families, who have seen us disappear, sometimes physically and other times mentally, to spend hours wrapped up in our own world of principles of economics. A project of this magnitude is very absorbing, and our families have been particularly supportive in this endeavor.

Arthur O'Sullivan

Steven Sheffrin

Stephen Perez

Introduction: What Is Economics?



Economics is the science of choice, exploring the choices made by individuals and organizations.

Over the last few centuries, these choices have led to substantial gains in the standard of living around the globe. In the United States, the typical person today has roughly seven times the income and purchasing power of a person 100 years ago. Our prosperity is the result of choices made by all sorts of people, including inventors, workers, entrepreneurs, and the people who saved money and loaned it to others to invest in

machines and other tools of production. One reason we have prospered is greater efficiency: We have discovered better ways to use our resources—raw materials, time, and energy—to produce the goods and services we value.

As an illustration of changes in the standard of living and our growing prosperity, let's compare the way people listened to music in 1891 with how we listen today. You can buy an iPod shuffle® for \$49 and fill it with 500 songs at \$0.99 each. If you earn a wage of \$15 per hour, it would take you about 36 hours of work to purchase and then fill an iPod. Back in 1891, the latest technological marvel was Thomas Edison's cylinder phonograph, which played music recorded on 4-inch cylinders. Imagine that you lived back then and wanted to get just as much music as you could fit on an iPod. Given the wages and prices in 1891, it would take you roughly 800 hours of work to earn enough money to buy the phonograph and all the cylinders. And if you wanted to keep your music with you, you would need 14 backpacks to carry the cylinders.

Although prosperity and efficiency are widespread, they are not universal. In some parts of the world, many people live in poverty. For example, in sub-Saharan Africa 388 million people—about half the population—live on less than \$1.25 per day. And in all nations of the world, inefficiencies still exist, with valuable resources being wasted. For example, each year the typical urban commuter in the United States wastes more than 47 hours and \$84 worth of gasoline stuck in rush-hour traffic.

CHAPTER OUTLINE AND LEARNING OBJECTIVES

1.1 **What Is Economics?**, page 2
List the three key economic questions.

1.2 **Economic Analysis and Modern Problems**, page 5
Discuss the insights from economics for a real-world problem such as congestion.

1.3 **The Economic Way of Thinking**, page 6
List the four elements of the economic way of thinking.

1.4 **Preview of Coming Attractions: Macroeconomics**, page 10
List three ways to use macroeconomics.

1.5 **Preview of Coming Attractions: Microeconomics**, page 11
List three ways to use microeconomics.

MyEconLab

MyEconLab helps you master each objective and study more efficiently.

Economics provides a framework to diagnose all sorts of problems faced by society and then helps create and evaluate various proposals to solve them. Economics can help us develop strategies to replace poverty with prosperity, and to replace waste with efficiency. In this chapter, we explain what economics is and how we all can use economic analysis to think about practical problems and solutions.

Learning Objective 1.1

List the three key economic questions.

scarcity

The resources we use to produce goods and services are limited.

economics

The study of choices when there is scarcity.

factors of production

The resources used to produce goods and services; also known as *production inputs* or *resources*.

natural resources

Resources provided by nature and used to produce goods and services.

labor

Human effort, including both physical and mental effort, used to produce goods and services.

physical capital

The stock of equipment, machines, structures, and infrastructure that is used to produce goods and services.

human capital

The knowledge and skills acquired by a worker through education and experience and used to produce goods and services.

entrepreneurship

The effort used to coordinate the factors of production—natural resources, labor, physical capital, and human capital—to produce and sell products.

What Is Economics?

Economists use the word *scarcity* to convey the idea that resources—the things we use to produce goods and services—are limited, while human wants are unlimited. Therefore, we cannot produce everything that everyone wants. As the old saying goes, you can't always get what you want. **Economics** studies the choices we make when there is scarcity; it is all about trade-offs. Here are some examples of scarcity and the trade-offs associated with making choices:

- You have a limited amount of time. If you take a part-time job, each hour on the job means one fewer hour for study or play.
- A city has a limited amount of land. If the city uses an acre of land for a park, it has one fewer acre for housing, retail, or industry.
- You have limited income this year. If you spend \$17 on a music CD, that's \$17 fewer you have to spend on other products or to save.

People produce goods (music CDs, houses, and parks) and services (the advice of physicians and lawyers) by using one or more of the following five **factors of production**, also called *production inputs* or simply *resources*:

- **Natural resources** are provided by nature. Some examples are fertile land, mineral deposits, oil and gas deposits, and water. Some economists refer to all types of natural resources as *land*.
- **Labor** is the physical and mental effort people use to produce goods and services.
- **Physical capital** is the stock of equipment, machines, structures, and infrastructure that is used to produce goods and services. Some examples are forklifts, machine tools, computers, factories, airports, roads, and fiber-optic cables.
- **Human capital** is the knowledge and skills acquired by a worker through education and experience. Every job requires some human capital: To be a surgeon, you must learn anatomy and acquire surgical skills. To be an accountant, you must learn the rules of accounting and acquire computer skills. To be a musician, you must learn to play an instrument.
- **Entrepreneurship** is the effort used to coordinate the factors of production—natural resources, labor, physical capital, and human capital—to produce and sell products. An entrepreneur comes up with an idea for a product, decides how to produce it, and raises the funds to bring it to the market. Some examples of entrepreneurs are Bill Gates of Microsoft, Steve Jobs of Apple Computer, Howard Schultz of Starbucks, and Ray Kroc of McDonald's.

Given our limited resources, we make our choices in a variety of ways. Sometimes we make our decisions as individuals, and other times we participate in collective decision making, allowing the government and other organizations to choose for us. Many of our choices happen within *markets*, institutions or arrangements that enable us to buy and sell things. For example, most of us participate in the labor market, exchanging our time for money, and we all participate in consumer markets, exchanging money for food and clothing. But we make other choices outside markets—from our personal decisions about everyday life to our political choices about matters that concern society as a whole. What unites all these decisions is the notion of scarcity: We can't have it all; there are trade-offs.

Economists are always reminding us that there is scarcity—there are trade-offs in everything we do. Suppose that in a conversation with your economics instructor you share your enthusiasm about an upcoming launch of the space shuttle. The economist may tell you that the resources used for the shuttle could have been used instead for an unmanned mission to Mars.

By introducing the notion of scarcity into your conversation, your instructor is simply reminding you that there are trade-offs, that one thing (a Mars mission) is sacrificed for another (a shuttle mission). Talking about alternatives is the first step in a process that can help us make better choices about how to use our resources. For example, we could compare the scientific benefits of a shuttle mission to the benefits of a Mars mission and choose the mission with the greater benefit.

Positive versus Normative Analysis

Economics doesn't tell us what to choose—shuttle mission or Mars mission—but simply helps us to understand the trade-offs. President Harry S. Truman once remarked,

All my economists say, “On the one hand, . . . ; On the other hand, . . . ?.” Give me a one-handed economist!

An economist might say, “On the one hand, we could use a shuttle mission to do more experiments in the gravity-free environment of Earth's orbit; on the other hand, we could use a Mars mission to explore the possibility of life on other planets.” In using both hands, the economist is not being evasive, but simply doing economics, discussing the alternative uses of our resources. The ultimate decision about how to use our resources—shuttle mission or Mars exploration—is the responsibility of citizens or their elected officials.

Most modern economics is based on **positive analysis**, which predicts the consequences of alternative actions by answering the question “What *is*?” or “What *will be*?” A second type of economic reasoning is normative in nature. **Normative analysis** answers the question “What *ought to be*?”

In Table 1.1, we compare positive questions to normative questions. Normative questions lie at the heart of policy debates. Economists contribute to policy debates by conducting positive analyses of the consequences of alternative actions. For example, an economist could predict the effects of an increase in the minimum wage on the number of people employed nationwide, the income of families with minimum-wage workers, and consumer prices. Armed with the conclusions of the economist's positive analysis, citizens and policymakers could then make a normative decision about whether to increase the minimum wage. Similarly, an economist could study the projects that could be funded with \$1 billion in foreign aid, predicting the effects of each project on the income per person in an African country. Armed with this positive analysis, policymakers could then decide which projects to support.

positive analysis

Answers the question “What *is*?” or “What *will be*?”

normative analysis

Answers the question “What *ought to be*?”

TABLE 1.1 Comparing Positive and Normative Questions

Positive Questions	Normative Questions
<ul style="list-style-type: none"> • If the government increases the minimum wage, how many workers will lose their jobs? • If two office-supply firms merge, will the price of office supplies increase? • How does a college education affect a person's productivity and earnings? • How do consumers respond to a cut in income taxes? • If a nation restricts shoe imports, who benefits and who bears the cost? 	<ul style="list-style-type: none"> • Should the government increase the minimum wage? • Should the government block the merger of two office-supply firms? • Should the government subsidize a college education? • Should the government cut taxes to stimulate the economy? • Should the government restrict imports?

Economists don't always reach the same conclusions in their positive analyses. The disagreements often concern the magnitude of a particular effect. For example, most economists agree that an increase in the minimum wage will cause unemployment, but disagree about how many people would lose their jobs. Similarly, economists agree that spending money to improve the education system in Africa will increase productivity and income, but disagree about the size of the increase in income. **MyEconLab** Concept Check

The Three Key Economic Questions: What, How, and Who?

We make economic decisions at every level in society. Individuals decide what products to buy, what occupations to pursue, and how much money to save. Firms decide what goods and services to produce and how to produce them. Governments decide what projects and programs to complete and how to pay for them. The choices of individuals, firms, and governments answer three questions:

- 1 *What products do we produce?* Trade-offs exist: If a hospital uses its resources to perform more heart transplants, it has fewer resources to care for premature infants.
- 2 *How do we produce the products?* Alternative means of production are available: Power companies can produce electricity with coal, natural gas, or wind power. Professors can teach in large lecture halls or small classrooms.
- 3 *Who consumes the products?* We must decide how to distribute the products of society. If some people earn more money than others, should they consume more goods? How much money should the government take from the rich and give to the poor?

As we'll see later in the book, most of these decisions are made in markets, where prices play a key role in determining what products we produce, how we produce them, and who gets the products. In Chapter 3, we examine the role of markets in modern economies and the role of government in market-based economies. **MyEconLab** Concept Check

Economic Models

Economists use *economic models* to explore the choices people make and the consequences of those choices. An economic model is a simplified representation of an economic environment, with all but the essential features of the environment eliminated. An **economic model** is an abstraction from reality that enables us to focus our attention on what really matters. As we'll see throughout the book, most economic models use graphs to represent the economic environment.

To see the rationale for economic modeling, consider an architectural model. An architect builds a scale model of a new building and uses the model to show how the building will fit on a plot of land and blend with nearby buildings. The model shows the exterior features of the building, but not the interior features. We can ignore the interior features because they are unimportant for the task at hand—seeing how the building will fit into the local environment.

Economists build models to explore decision making by individuals, firms, and other organizations. For example, we can use a model of a profit-maximizing firm to predict how a firm will respond to increased competition. If a new car stereo store opens up in your town, will the old firms be passive and simply accept smaller market shares, or will they aggressively cut their prices to try to drive the new rival out of business? The model of the firm includes the monetary benefits and costs of doing business, and assumes that firms want to make as much money as possible. Although there may be other motives in the business world—to have fun or to help the world—the economic model ignores these other motives. The model focuses our attention on the profit motive and how it affects a firm's response to increased competition.

economic model

A simplified representation of an economic environment, often employing a graph.

Economic Analysis and Modern Problems

Economic analysis provides important insights into real-world problems. To explain how we can use economic analysis in problem solving, we provide three examples. You'll see these examples again in more detail later in the book.

Learning Objective 1.2

Discuss the insights from economics for a real-world problem such as congestion.

Economic View of Traffic Congestion

Consider first the problem of traffic congestion. According to the Texas Transportation Institute, the typical U.S. commuter wastes about 47 hours per year because of traffic congestion.¹ In some cities, the time wasted is much greater: 93 hours in Los Angeles, 72 hours in San Francisco, and 63 hours in Houston. In addition to time lost, we also waste 2.3 billion gallons of gasoline and diesel fuel each year.

To an economist, the diagnosis of the congestion problem is straightforward. When you drive onto a busy highway during rush hour, your car takes up space and decreases the distance between the vehicles on the highway. A driver's normal reaction to a shorter distance between moving cars is to slow down. So when you enter the highway, you force other commuters to slow down and thus spend more time on the highway. If each of your 900 fellow commuters spends just two extra seconds on the highway, you will increase the total travel time by 30 minutes. In deciding whether to use the highway, you will presumably ignore these costs you impose on others. Similarly, your fellow commuters ignore the cost they impose on you and others when they enter the highway. Because no single commuter pays the full cost (30 minutes), too many people use the highway, and everyone wastes time.

One possible solution to the congestion problem is to force people to pay for using the road, just as they pay for gasoline and tires. The government could impose a congestion tax of \$8 per trip on rush-hour commuters and use a debit card system to collect the tax: Every time a car passes a checkpoint, a transponder would charge the commuter's card. Traffic volume during rush hours would then decrease as travelers (a) shift their travel to off-peak times, (b) switch to ride-sharing and mass transit, and (c) shift their travel to less congested routes. The job for the economist is to compute the appropriate congestion tax and predict the consequences of imposing it.

MyEconLab Concept Check

Economic View of Poverty in Africa

Consider next the issue of poverty in Africa. In the final two decades of the twentieth century, the world economy grew rapidly, and the average per capita income (income per person) increased by about 35 percent. In contrast, the economies of poverty-stricken sub-Saharan Africa shrank, and per capita income *decreased* by about 6 percent. Africa is the world's second-largest continent in both area and population and accounts for more than 12 percent of the world's human population. Figure 1.1 shows a map of Africa. The countries of sub-Saharan Africa are highlighted in orange.

Economists have found that as a nation's economy grows, its poorest households share in the general prosperity.² Therefore, one way to reduce poverty in sub-Saharan Africa is to increase economic growth. Economic growth occurs when a country expands its production facilities (machinery and factories), improves its public infrastructure (highways and water systems), widens educational opportunities, and adopts new technology.

The recent experience of sub-Saharan Africa is somewhat puzzling because in the last few decades the region has expanded educational opportunities and received large amounts of foreign aid. Some recent work by economists on the sources of growth suggests that institutions such as the legal system and the regulatory environment also play key roles in economic growth.³ In sub-Saharan Africa, a simple legal dispute about a small debt takes about 30 months to resolve, compared to 5 months in the United States. In Mozambique, it takes 174 days to complete the procedures required to set up a business, compared to just 2 days in Canada. In many cases, institutions impede



▲ **FIGURE 1.1** Map of Africa

Africa is the world's second-largest continent in both area and population, and accounts for more than 12 percent of the world's human population. The countries of sub-Saharan Africa are highlighted in green.

rather than encourage the sort of investment and risk-taking—called *entrepreneurship*—that causes economic growth and reduces poverty. As a consequence, economists and policymakers are exploring ways to reform the region's institutions. They are also challenged with choosing among development projects that will generate the biggest economic boost per dollar spent—the biggest bang per buck. **MyEconLab** **Concept Check**

Economic View of the Current World Recession

Over the last several decades, the U.S. economy has performed well and has raised our standard of living. The general consensus was that our policymakers had learned to manage the economy effectively. Although the economy faltered at times, policymakers seemed to know how to restore growth and prosperity.

That is why the financial crisis and the recession that began in late 2007 has so shaken the confidence of people in the United States and around the world. The problems started innocently enough, with a booming market for homes that was fueled by easy credit from financial institutions. But we later discovered that many purchasers of homes and properties could not really afford them, and when many homeowners had trouble making their mortgage payments, the trouble spread to banks and other financial institutions. As a result, businesses found it increasingly difficult to borrow money for everyday use and investment, and economic activity around the world began to contract.

The major countries of the world have implemented aggressive policies to try to halt this downturn. Policymakers want to avoid the catastrophes that hit the global economy in the 1930s. Fortunately, they can draw on many years of experience in economic policy to guide the economy during this difficult time. **MyEconLab** **Concept Check**

MyEconLab Study Plan

Learning Objective 1.3

List the four elements of the economic way of thinking.

The Economic Way of Thinking

How do economists think about problems and decision making? The economic way of thinking is best summarized by British economist John Maynard Keynes (1883–1946):⁴

The theory of economics does not furnish a body of settled conclusions immediately applicable to policy. It is a method rather than a doctrine, an apparatus of the mind, a technique of thinking which helps its possessor draw correct conclusions.

Let's look at the four elements of the economic way of thinking.

Use Assumptions to Simplify

Economists use assumptions to make things simpler and focus attention on what really matters. If you use a road map to plan a car trip from Seattle to San Francisco, you make two unrealistic assumptions to simplify your planning:

- The earth is flat: The flat road map doesn't show the curvature of the earth.
- The roads are flat: The standard road map doesn't show hills and valleys.

Instead of a map, you could use a globe that shows all the topographical features between Seattle and San Francisco, but you don't need those details to plan your trip. A map, with its unrealistic assumptions, will suffice because the curvature of the earth and the topography of the highways are irrelevant to your trip. Although your analysis is based on two unrealistic assumptions, that does not mean your analysis is invalid. Similarly, if economic analysis is based on unrealistic assumptions, that doesn't mean the analysis is faulty.

What if you decide to travel by bike instead of by automobile? Now the assumption of flat roads really matters, unless of course you are eager to pedal up and down mountains. If you use a standard map, and thus assume there are no mountains between the two cities, you may inadvertently pick a mountainous route instead of a flat one. In this case, the simplifying assumption makes a difference. The lesson is that we must think carefully about whether a simplifying assumption is truly harmless.

MyEconLab Concept Check

Isolate Variables—*Ceteris Paribus*

Economic analysis often involves variables and how they affect one another. A **variable** is a measure of something that can take on different values, for example, your grade point average. Economists are interested in exploring relationships between two variables—like the relationship between the price of apples and the quantity of apples consumers purchase. Of course, the quantity of apples purchased depends on many other variables, including the consumer's income. To explore the relationship between the quantity and price of apples, we must assume that the consumer's income—and anything else that influences apple purchases—doesn't change during the time period we're considering.

Alfred Marshall (1842–1924) was a British economist who refined the economic model of supply and demand and provided a label for this process.⁵ He picked one variable that affected apple purchases (price) and threw the other variable (income) into what he called the “pound” (in Marshall's time, the “pound” was an enclosure for holding stray cattle; nowadays, a pound is for stray dogs). That variable waited in the pound while Marshall examined the influence of the first variable. Marshall labeled the pound *ceteris paribus*, the Latin expression meaning that other variables are held fixed:

... the existence of other tendencies is not denied, but their disturbing effect is neglected for a time. The more the issue is narrowed, the more exactly can it be handled.

This text contains many statements about the relationship between two variables. For example, the quantity of computers produced by Dell depends on the price of computers, the wage of computer workers, and the cost of microchips. When we say, “An increase in the price of computers increases the quantity of computers produced,” we are assuming that the other two variables—the wage and the cost of microchips—do not change. That is, we apply the *ceteris paribus* assumption.

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Think at the Margin

Economists often consider how a small change in one variable affects another variable and what impact that has on people's decision making. In other words, if circumstances change only slightly, how will people respond? A small, one-unit change in value is called a **marginal change**. The key feature of marginal change is that the first variable

variable

A measure of something that can take on different values.

ceteris paribus

The Latin expression meaning that other variables are held fixed.

marginal change

A small, one-unit change in value.

changes by only one unit. For example, you might ask, “If I study just one more hour, by how much will my exam score increase?” Economists call this process “thinking at the margin.” Thinking at the margin is like thinking on the edge. You will encounter marginal thinking throughout this text. Here are some other marginal questions:

- If I keep my barber shop open one more hour, by how much will my revenue increase?
- If I stay in school and earn another degree, by how much will my lifetime earnings increase?
- If a car dealer hires one more sales associate, how many more cars will the dealer sell?

As we’ll see in the next chapter, economists use the answer to a marginal question as a first step in deciding whether to do more or less of something, for example, whether to keep your barber shop open one more hour.

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Rational People Respond to Incentives

A key assumption of most economic analysis is that people act rationally, meaning they act in their own self-interest. Scottish philosopher Adam Smith (1723–1790), who is also considered the founder of economics, wrote that he discovered within humankind⁶

a desire of bettering our condition, a desire which, though generally calm and dispassionate, comes with us from the womb, and never leaves us until we go to the grave.

Smith didn’t say people are motivated exclusively by self-interest, but rather that self-interest is more powerful than kindness or altruism. In this text, we will assume that people act in their own self-interest. Rational people respond to incentives. When the payoff, or benefit, from doing something changes, people change their behavior to get the benefit.

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Application 1

INCENTIVES TO BUY HYBRID VEHICLES

APPLYING THE CONCEPTS #1: How do people respond to incentives?



Consider the incentives to buy a hybrid vehicle, which is more fuel efficient but more expensive than a gas-powered vehicle. Between 2000 and 2007, the number of hybrid vehicles increased from fewer than 10,000 vehicles to more than 340,000 vehicles. Over this period, the price of gasoline increased significantly, and the higher price of gasoline was responsible for roughly one-third of the hybrid vehicles purchased in 2007. An additional factor in hybrid purchases was a federal subsidy of

up to \$3,400 per hybrid vehicle. The subsidy was responsible for roughly one-fifth of the hybrid vehicles purchased in 2007. The increase in the number of hybrid vehicles decreased the emission of the greenhouse gas carbon dioxide (CO₂).

How efficient is the hybrid subsidy in reducing CO₂? On average, the cost of abating one ton of CO₂ through the hybrid subsidy is \$177. There are less costly ways to reduce CO₂ emissions, including building insulation, energy-efficient lighting, reforestation, and switching to electric power systems that use fuels that generate less CO₂. For example, a switch from coal to natural gas in power plants reduces CO₂ emissions at less than one-third the cost associated with the hybrid subsidy. **Related to Exercise 3.4.**

SOURCES: (1) Arie Beresteanu and Shanjun Li, “Gasoline Prices, Government Support, and the Demand for Hybrid Vehicles in the United States,” *International Economic Review* 52 (2011), pp. 161–182. (2) Jackie Calmes, “President Pushes to Add More Credits for Hybrids,” *New York Times*, March 8, 2012.

Example: London Addresses Its Congestion Problem

To illustrate the economic way of thinking, let's consider again how an economist would approach the problem of traffic congestion. Recall that each driver on the highway slows down other drivers but ignores these time costs when deciding whether to use the highway. If the government imposes a congestion tax to reduce traffic during rush hour, the economist is faced with a question: How high should the tax be?

To determine the appropriate congestion tax, an economist would assume that people respond to incentives and use the three other elements of the economic way of thinking:

- **Use assumptions to simplify.** To simplify the problem, we would assume that every car has the same effect on the travel time of other cars. Of course, this is unrealistic because people drive cars of different sizes in different ways. But the alternative—looking at the effects of each car on travel speeds—would needlessly complicate the analysis.
- **Isolate variables—use *ceteris paribus*.** To focus attention on the effects of a congestion tax on the number of cars using the highway, we would make the *ceteris paribus* assumption that everything else that affects travel behavior—the price of gasoline, bus fares, and consumer income—remains fixed.
- **Think at the margin.** To think at the margin, we would estimate the effects of adding one more car to the highway. Now consider the marginal question: If we add one more car to the highway, by how much does the total travel time for commuters increase? Once we answer this question, we can determine the cost imposed by the marginal driver. If the marginal driver forces each of the 900 commuters to spend two extra seconds on the highway, total travel time increases by 30 minutes. If the value of time is, say, \$16 per hour, the appropriate congestion tax would be \$8 (equal to $\$16 \times 1/2$ hour).

Application 2

HOUSING PRICES IN CUBA

APPLYING THE CONCEPTS #2: What is the role of prices in allocating resources?



As an illustration of the role of prices in an economy, consider the experience of Cuba without housing prices. In 1960, the government confiscated most housing and outlawed its sale and rental. Tenants who paid monthly rent to the government

for 20 years became homeowners of sorts—they officially owned the dwelling, but could not sell it or rent it to others. The impossibility of resale and rental meant that homeowners had less incentive to repair and maintain their property. As a result, a large fraction of the housing stock is in mediocre or poor condition (30 percent in 2013). In addition, few new dwellings were built in the last 50 years, leading to a large housing deficit (roughly 1 million dwellings in 2013).

Housing reforms in 2011 restored prices to the Cuban housing market. The reforms authorize the sale and purchase of homes for Cuban citizens at prices chosen by sellers and buyers. Economists expect these reforms to provide homeowners with greater incentives to repair and maintain their dwellings, and to increase housing construction. **Related to Exercise 3.5.**

SOURCES: (1) Carmelo Mesa-Lago, *Institutional Changes of Cuba's Economic Social Reforms: State and Market Roles, Progress, Hurdles, Comparisons, Monitoring and Effects* (Washington, DC: Brookings, 2014). (2) Damien Cave, "Cuba to Allow Buying and Selling of Property, With Few Restrictions," *New York Times*, November 3, 2011.