### Brief Contents

**PART 1 Introduction and Key Principles**

1. Introduction: What Is Economics?  1  
2. The Key Principles of Economics  28  
3. Exchange and Markets  49  
4. Demand, Supply, and Market Equilibrium  65

**PART 2 The Basic Concepts in Macroeconomics**

5. Measuring a Nation's Production and Income  97  
6. Unemployment and Inflation  120

**PART 3 The Economy in the Long Run**

7. The Economy at Full Employment  139  
8. Why Do Economies Grow?  158

**PART 4 Economic Fluctuations and Fiscal Policy**

9. Aggregate Demand and Aggregate Supply  185  
10. Fiscal Policy  205  
11. The Income-Expenditure Model  223  
12. Investment and Financial Markets  253

**PART 5 Money, Banking, and Monetary Policy**

13. Money and the Banking System  272  
14. The Federal Reserve and Monetary Policy  291

**PART 6 Inflation, Unemployment, and Economic Policy**

15. Modern Macroeconomics: From the Short Run to the Long Run  311  
16. The Dynamics of Inflation and Unemployment  329  
17. Macroeconomic Policy Debates  347

**PART 7 The International Economy**

18. International Trade and Public Policy  364  
19. The World of International Finance  385

**PART 8 A Closer Look at Demand and Supply**

20. Elasticity: A Measure of Responsiveness  409  
21. Market Efficiency and Government Intervention  437  
22. Consumer Choice Using Utility Theory  462

**PART 9 Market Structures and Pricing**

23. Production Technology and Cost  493  
24. Perfect Competition  514  
25. Monopoly and Price Discrimination  538  
26. Market Entry and Monopolistic Competition  558  
27. Oligopoly and Strategic Behavior  574  
28. Controlling Market Power: Antitrust and Regulation  601

**PART 10 Externalities and Information**

29. Imperfect Information: Adverse Selection and Moral Hazard  617  
30. Public Goods and Public Choice  643  
31. External Costs and Environmental Policy  660

**PART 11 The Labor Market and Income Distribution**

32. The Labor Market, Income, and Poverty  681  
33. Unions, Monopsony, and Imperfect Information  705
The Cost of Military Spending 30
Opportunity Cost and the Production Possibilities Curve 31

APPLICATION 1 Don't Forget the Costs of Time and Invested Funds 32

The Marginal Principle 33
How Many Movie Sequels? 34
Renting College Facilities 35
Automobile Emissions Standards 36

APPLICATION 2 Why Not Walk up an Escalator? 36
Driving Speed and Safety 37

The Principle of Voluntary Exchange 37
Exchange and Markets 37

APPLICATION 3 Jasper Johns and Housepainting 38
Online Games and Market Exchange 38

The Principle of Diminishing Returns 39
APPLICATION 4 Fertilizer and Crop Yields 39
Diminishing Returns from Sharing a Production Facility 40

The Real-Nominal Principle 40
APPLICATION 5 The Declining Real Minimum Wage 41
APPLICATION 6 Repaying Student Loans 42

* SUMMARY 43 * KEY TERMS 43 * EXERCISES 43

3 Exchange and Markets 49

Comparative Advantage and Exchange 50
Specialization and the Gains from Trade 50
Comparative Advantage versus Absolute Advantage 52
The Division of Labor and Exchange 52

Comparative Advantage and International Trade 53
Outsourcing 53
APPLICATION 1 Candy Cane Makers Move to Mexico for Cheap Sugar 54

Markets 55
Virtues of Markets 55
The Role of Entrepreneurs 56

APPLICATION 2 Gold Farming for World of Warcraft 57
Example of the Emergence of Markets: POW Camps 57
APPLICATION 3 The Shakers and the Market for Garden Seeds 58

Market Failure and the Role of Government 58
Government Enforces the Rules of Exchange 59
Government Can Reduce Economic Uncertainty 60

* SUMMARY 60 * KEY TERMS 61 * EXERCISES 61

4 Demand, Supply, and Market Equilibrium 65

The Demand Curve 66
The Individual Demand Curve and the Law of Demand 66
From Individual Demand to Market Demand 68
The Supply Curve 69
The Individual Supply Curve and the Law of Supply 69
Why Is the Individual Supply Curve Positively Sloped? 71
From Individual Supply to Market Supply 71
Why Is the Market Supply Curve Positively Sloped? 73
Market Equilibrium: Bringing Demand and Supply Together 73
Excess Demand Causes the Price to Rise 74
Excess Supply Causes the Price to Drop 75
Market Effects of Changes in Demand 75
Change in Quantity Demanded versus Change in Demand 75
Increases in Demand Shift the Demand Curve 76
Decreases in Demand Shift the Demand Curve 78
A Decrease in Demand Decreases the Equilibrium Price 79
Market Effects of Changes in Supply 79
Change in Quantity Supplied versus Change in Supply 79
Increases in Supply Shift the Supply Curve 81
An Increase in Supply Decreases the Equilibrium Price 82
Decreases in Supply Shift the Supply Curve 83
A Decrease in Supply Increases the Equilibrium Price 83
Simultaneous Changes in Demand and Supply 84
Predicting and Explaining Market Changes 86
Applications of Demand and Supply 86
APPLICATION 1 Hurricane Katrina and Baton Rouge Housing Prices 87
APPLICATION 2 Honeybees and the Price of Ice Cream 87
APPLICATION 3 The Supply and Demand for Cruise Ship Berths 88
APPLICATION 4 The Bouncing Price of Vanilla Beans 89
APPLICATION 5 Drought in Australia and the Price of Rice 90
* SUMMARY 91 * KEY TERMS 91
* EXERCISES 91
* ECONOMIC EXPERIMENT 95

PART 2 The Basic Concepts in Macroeconomics

5 Measuring a Nation’s Production and Income 97
The “Flip” Sides of Macroeconomic Activity: Production and Income 98
The Circular Flow of Production and Income 99
The Production Approach: Measuring a Nation’s Macroeconomic Activity Using Gross Domestic Product 100
The Components of GDP 102
Putting It All Together: The GDP Equation 105
The Income Approach: Measuring a Nation’s Macroeconomic Activity Using National Income 105
Measuring National Income 105
Measuring National Income through Value Added 107
APPLICATION 1 Using Value Added to Measure the True Size of Wal-Mart 107
An Expanded Circular Flow 108
A Closer Examination of Nominal and Real GDP 108
Measuring Real versus Nominal GDP 109
How to Use the GDP Deflator 110
6 Unemployment and Inflation 120

Examining Unemployment 121

- How Is Unemployment Defined and Measured? 121
- Alternative Measures of Unemployment and Why They Are Important 122

APPLICATION 1 After Growing Sharply, Women's Labor Force Participation has Leveled Off 123

- Who Are the Unemployed? 124

APPLICATION 2 More Disability, Less Unemployment? 125

Categories of Unemployment 126

- Types of Unemployment: Cyclical, Frictional, and Structural 126
- The Natural Rate of Unemployment 127

The Costs of Unemployment 128

APPLICATION 3 Social Norms, Unemployment, and Perceived Happiness 129

The Consumer Price Index and the Cost of Living 129

- The CPI versus the Chain Index for GDP 130
- Problems in Measuring Changes in Prices 131

APPLICATION 4 The Introduction of Cell Phones and the Bias in the CPI 132

Inflation 132

- Historical U.S. Inflation Rates 133
- The Perils of Deflation 133
- The Costs of Inflation 134
- Anticipated Inflation 134
- Unanticipated Inflation 135

* SUMMARY 136 * KEY TERMS 136
* EXERCISES 136

PART 3 The Economy in the Long Run

7 The Economy at Full Employment 139

Wage and Price Flexibility and Full Employment 140

The Production Function 140

Wages and the Demand and Supply for Labor 143

- Labor Market Equilibrium 143
- Changes in Demand and Supply 144

APPLICATION 1 The Black Death and Living Standards in Old England 145

Labor Market Equilibrium and Full Employment 145

Using the Full-Employment Model 147

- Taxes and Potential Output 147
- Real Business Cycle Theory 148

APPLICATION 2 A Nobel Laureate Explains Why Europeans Work Less Than U.S. Workers or the Japanese 149

APPLICATION 3 Can Labor Market Policies Account for the Great Depression? 151
Dividing Output among Competing Demands for GDP at Full Employment  151

International Comparisons  152
Crowding Out in a Closed Economy  152
Crowding Out in an Open Economy  153
Crowding In  154

* SUMMARY  155  * KEY TERMS  155
* EXERCISES  155

8 Why Do Economies Grow?  158

Economic Growth Rates  159
Measuring Economic Growth  160
Comparing the Growth Rates of Various Countries  161
APPLICATION 1 Global Warming, Rich Countries, and Poor Countries  162
Are Poor Countries Catching Up?  163
APPLICATION 2 Growth Need Not Cause Increased Inequality  164
Capital Deepening  164
Saving and Investment  165
How Do Population Growth, Government, and Trade Affect Capital Deepening?  166
The Key Role of Technological Progress  168
How Do We Measure Technological Progress?  168
APPLICATION 3 Sources of Growth in China and India  169
Using Growth Accounting  170
APPLICATION 4 Growth Accounting and Information Technology  170
What Causes Technological Progress?  171
Research and Development Funding  171
Monopolies That Spur Innovation  172
The Scale of the Market  172
Induced Innovations  172
Education, Human Capital, and the Accumulation of Knowledge  172
APPLICATION 5 The Role of Political Factors in Economic Growth  173
APPLICATION 6 Culture, Evolution, and Economic Growth  174
New Growth Theory  174
A Key Governmental Role: Providing the Correct Incentives and Property Rights  175
APPLICATION 7 Lack of Property Rights Hinders Growth in Peru  176
* SUMMARY  177  * KEY TERMS  177
* EXERCISES  177
APPENDIX A: A Model of Capital Deepening  180

PART 4 Economic Fluctuations and Fiscal Policy

9 Aggregate Demand and Aggregate Supply  185

Sticky Prices and Their Macroeconomic Consequences  186
Flexible and Sticky Prices  186
How Demand Determines Output in the Short Run  187
APPLICATION 1 Measuring Price Stickiness in Consumer Markets  188
Understanding Aggregate Demand  188
What Is the Aggregate Demand Curve?  188
The Components of Aggregate Demand 189
Why the Aggregate Demand Curve Slopes Downward 189
Shifts in the Aggregate Demand Curve 190
How the Multiplier Makes the Shift Bigger 192
Understanding Aggregate Supply 195
The Long-Run Aggregate Supply Curve 195
The Short-Run Aggregate Supply Curve 196
APPLICATION 2 Two Approaches to Determining the Causes of Recessions 198
APPLICATION 3 How the U.S. Economy Has Coped with Oil Price Fluctuations 199
Supply Shocks 199
From the Short Run to the Long Run 200
Looking Ahead 201
* SUMMARY 220 * KEY TERMS 220 * EXERCISES 221

10 Fiscal Policy 205
The Role of Fiscal Policy 206
Fiscal Policy and Aggregate Demand 206
The Fiscal Multiplier 207
The Limits to Stabilization Policy 208
The Federal Budget 210
Federal Spending 210
APPLICATION 1 Increasing Life Expectancy and Aging Populations Spur Costs of Entitlement Programs 212
Federal Revenues 212
APPLICATION 2 The Confucius Curve? 214
The Federal Deficit and Fiscal Policy 214
Automatic Stabilizers 215
Are Deficits Bad? 215
Fiscal Policy in U.S. History 216
The Depression Era 216
The Kennedy Administration 217
The Vietnam War Era 217
The Reagan Administration 218
The Clinton and George W. Bush Administrations 218
APPLICATION 3 Evaluating the Obama Fiscal Stimulus 219

11 The Income-Expenditure Model 223
A Simple Income-Expenditure Model 224
Equilibrium Output 224
Adjusting to Equilibrium Output 225
The Consumption Function 227
Consumer Spending and Income 227
Changes in the Consumption Function 227
APPLICATION 1 Falling Home Prices, the Wealth Effect, and Decreased Consumer Spending 229
Equilibrium Output and the Consumption Function 229
Saving and Investment 231
Understanding the Multiplier 232
APPLICATION 2 Using Long-Term Macro Data to Measure Multipliers 233
Government Spending and Taxation 234
Fiscal Multipliers 234
14 The Federal Reserve and Monetary Policy 291

The Money Market 292

The Demand for Money 292

How the Federal Reserve Can Change the Money Supply 294

Open Market Operations 295

Other Tools of the Fed 295

APPLICATION 1 Beyond Purchasing Treasury Securities 296

How Interest Rates are Determined: Combining the Demand and Supply of Money 297

Interest Rates and Bond Prices 298

APPLICATION 2 Rising Interest Rates During an Economic Recovery 300

Interest Rates and How They Change Investment and Output (GDP) 301

Monetary Policy and International Trade 303

Monetary Policy Challenges for the Fed 304

APPLICATION 3 The Effectiveness of Committees 305

Lags in Monetary Policy 305

Influencing Market Expectations: From the Federal Funds Rate to Interest Rates on Long-Term Bonds 306

Looking Ahead: From the Short Run to the Long Run 307

* SUMMARY 307 * KEY TERMS 308
* EXERCISES 308

PART 6 Inflation, Unemployment, and Economic Policy

15 Modern Macroeconomics: From the Short Run to the Long Run 311

Linking the Short Run and the Long Run 312

The Difference between the Short and Long Run 312

Wages and Prices and Their Adjustment over Time 312

How Wage and Price Changes Move the Economy Naturally Back to Full Employment 313

Returning to Full Employment from a Recession 314

Returning to Full Employment from a Boom 315

Economic Policy and the Speed of Adjustment 315

APPLICATION 1 Avoiding a Liquidity Trap 317

Liquidity Traps 317

Political Business Cycles 317

APPLICATION 2 Elections, Political Parties, and Voter Expectations 318

Understanding the Economics of the Adjustment Process 318

The Long-Run Neutrality of Money 320

Crowding Out in the Long Run 322

APPLICATION 3 Increasing Health-Care Expenditures and Crowding Out 323
16 The Dynamics of Inflation and Unemployment 329

Money Growth, Inflation, and Interest Rates 330

Inflation in a Steady State 330

How Changes in the Growth Rate of Money Affect the Steady State 331

Understanding the Expectations Phillips Curve: The Relationship Between Unemployment and Inflation 332

Are the Public's Expectations about Inflation Rational? 333

U.S. Inflation and Unemployment in the 1980s 334

Shifts in the Natural Rate of Unemployment in the 1990s 335

APPLICATION 1 Shifts in the Natural Rate of Unemployment 336

How the Credibility of a Nation's Central Bank Affects Inflation 337

APPLICATION 2 Increased Political Independence for the Bank of England Lowered Inflation Expectations 339

Inflation and the Velocity of Money 339

Hyperinflation 341

How Budget Deficits Lead to Hyperinflation 342

APPLICATION 3 Hyperinflation in Zimbabwe 343

17 Macroeconomic Policy Debates 347

Should We Balance the Federal Budget? 348

The Budget in Recent Decades 348

Five Debates about Deficits 350

APPLICATION 1 New Methods to Measure the Long-Term Fiscal Imbalances for the United States 353

Should the Fed Target Inflation or Pursue Other Objectives? 355

Two Debates about Inflation Targeting 355

APPLICATION 2 Would a Policy Rule Have Prevented the Housing Boom? 356

Should We Tax Consumption Rather than Income? 358

Two Debates about Consumption Taxation 358

APPLICATION 3 Is a VAT in Our Future? 360

* SUMMARY 344 * KEY TERMS 344
* EXERCISES 344
* ECONOMIC EXPERIMENT 346

PART 7 The International Economy

18 International Trade and Public Policy 364

Benefits from Specialization and Trade 365

Production Possibilities Curve 365

Comparative Advantage and the Terms of Trade 367

The Consumption Possibilities Curve 367

How Free Trade Affects Employment 368
Protectionist Policies 369
Import Bans 369
Quotas and Voluntary Export Restraints 370
APPLICATION 1 The Impact of Tariffs on the Poor 371
Responses to Protectionist Policies 372
What are the Rationales for Protectionist Policies? 372
To Shield Workers from Foreign Competition 373
To Nurture Infant Industries until They Mature 373
To Help Domestic Firms Establish Monopolies in World Markets 373
APPLICATION 2 Protection for Candle Makers 374
A Brief History of International Tariff and Trade Agreements 374
Recent Policy Debates and Trade Agreements 376
Are Foreign Producers Dumping Their Products? 376
APPLICATION 3 Are They Really Dumping? 376
Do Trade Laws Inhibit Environmental Protection? 377
APPLICATION 4 Trade, Consumption, and Inequality 379
Do Outsourcing and Trade Cause Income Inequality? 379
Why Do People Protest Free Trade? 380
* SUMMARY 381 * KEY TERMS 381 * EXERCISES 381

19 The World of International Finance 385
How Exchange Rates Are Determined 386
What Are Exchange Rates? 386
How Demand and Supply Determine Exchange Rates 387
Changes in Demand or Supply 388
Real Exchange Rates and Purchasing Power Parity 390
APPLICATION 1 The Chinese Yuan and Big Macs 392
The Current Account, the Financial Account, and the Capital Account 393
Rules for Calculating the Current, Financial, and Capital Accounts 394
APPLICATION 2 World Savings and U.S. Current Account Deficits 396
Fixed and Flexible Exchange Rates 397
Fixing the Exchange Rate 398
Fixed versus Flexible Exchange Rates 399
The U.S. Experience with Fixed and Flexible Exchange Rates 400
Exchange Rate Systems Today 401
APPLICATION 3 A Downside to the Euro 402
Managing Financial Crises 402
APPLICATION 4 The Argentine Financial Crisis 403
* SUMMARY 405 * KEY TERMS 405 * EXERCISES 405
* ECONOMIC EXPERIMENT 408
PART 8 A Closer Look at Demand and Supply

20 Elasticity: A Measure of Responsiveness 409

The Price Elasticity of Demand 410
Computing Percentage Changes and Elasticities 411
Price Elasticity and the Demand Curve 412
Elasticity and the Availability of Substitutes 412
Other Determinants of the Price Elasticity of Demand 414
APPLICATION 1 A Closer Look at the Elasticity of Demand for Gasoline 415
Using Price Elasticity to Predict Changes in Quantity 416
Beer Prices and Highway Deaths 416
Cigarette Prices and Teenagers 416
Price Elasticity and Total Revenue 417
Elastic versus Inelastic Demand 417
Using Elasticity to Predict the Revenue Effects of Price Changes 418
APPLICATION 2 Vanity Plates and the Elasticity of Demand 419
Elasticity and Total Revenue for a Linear Demand Curve 420
Price Elasticity along a Linear Demand Curve 420
Elasticity and Total Revenue for a Linear Demand Curve 421
Other Elasticities of Demand 422

Income Elasticity of Demand 422
Cross-Price Elasticity of Demand 422
APPLICATION 3 I Can Find that Elasticity in Four Clicks! 423
The Price Elasticity of Supply 424
What Determines the Price Elasticity of Supply? 425
The Role of Time: Short-Run versus Long-Run Supply Elasticity 425
Extreme Cases: Perfectly Inelastic Supply and Perfectly Elastic Supply 426
Predicting Changes in Quantity Supplied 427
Using Elasticities to Predict Changes in Equilibrium Price 427
The Price Effects of a Change in Demand 427
The Price Effects of a Change in Supply 429
APPLICATION 4 Milk Prices in the Short Run and Long Run 430
* SUMMARY 431 * KEY TERMS 431
* EXERCISES 432

21 Market Efficiency and Government Intervention 437

Consumer Surplus and Producer Surplus 438
The Demand Curve and Consumer Surplus 439
The Supply Curve and Producer Surplus 440
Market Equilibrium and Efficiency 441
Total Surplus Is Lower with a Price below the Equilibrium Price 441
Total Surplus Is Lower with a Price above the Equilibrium Price 442
Efficiency and the Invisible Hand 443
Government Intervention in Efficient Markets 443

Controlling Prices—Maximum and Minimum Prices 444
Setting Maximum Prices 444
Rent Control 444
Setting Minimum Prices 446

Controlling Quantities—Licensing and Import Restrictions 446
Taxi Medallions 446
Licensing and Market Efficiency 447
Winners and Losers from Licensing 448
Import Restrictions 448

APPLICATION 1 Used Cars to Mexico: 1998
Cars Only 450

APPLICATION 2 Supply and Demand for Human Organs 450

Who Really Pays Taxes? 451
Tax Shifting: Forward and Backward 451
Tax Shifting and the Price Elasticity of Demand 452
Cigarette Taxes and Tobacco Land 453
The Luxury Boat Tax and Boat Workers 453
Tax Burden and Deadweight Loss 453

APPLICATION 3 Response to Lower Taxes in French Restaurants 455

APPLICATION 4 Taxing Mobile Phones in Africa 455

* SUMMARY 456 * KEY TERMS 456
* EXERCISES 456
* ECONOMIC EXPERIMENT 461

22 Consumer Choice Using Utility Theory 462

Total and Marginal Utility 463
Consumer Choice 464
Consumer Constraints: The Budget Line 464
Making Choices Using the Equimarginal Rule 465
Bundling of Goods and iTunes 467

APPLICATION 1 A Tax on Soft Drinks 468

The Individual Demand Curve 468
The Income and Substitution Effects of a Price Change 469
Points on the Demand Curve 470
Example: Substitution Effect of a Gasoline Tax 470

APPLICATION 2 The Price of Pirate Songs 471

Consumer Puzzles—Free Goods and Branding 471

APPLICATION 3 The Big Difference Between $0.20 and FREE! 472

APPLICATION 4 Neuroscience and the Cola Challenge 472

* SUMMARY 473 * KEY TERMS 473
* EXERCISES 473

APPENDIX: Consumer Choice with Indifference Curves 477
CONSUMER CONSTRAINTS AND PREFERENCES 477
MAXIMIZING UTILITY 480

APPLICATION 1 What's Your MRS? 483

APPLICATION 2 The Big Difference between $0.20 and Free! 484
PART 9 Market Structures and Pricing

23 Production Technology and Cost 493

Economic Cost and Economic Profit 494
A Firm with a Fixed Production Facility:
  Short-Run Costs 495
    Production and Marginal Product 495
  Short-Run Total Cost 496
  Short-Run Average Costs 498
  Short-Run Marginal Cost 499
  The Relationship between Marginal Cost and Average Cost 500
Production and Cost in the Long Run 501
  Expansion and Replication 501
  Reducing Output with Indivisible Inputs 503
  Scaling Down and Labor Specialization 503
  Economies of Scale 504
  Diseconomies of Scale 504
  Actual Long-Run Average-Cost Curves 505
  Short-Run versus Long-Run Average Cost 506
Applications of Production Cost 506
APPLICATION 1 The Production Cost of Mobile Phones 506
APPLICATION 2 Indivisible Inputs and the Cost of Fake Killer Whales 507
APPLICATION 3 Scale Economies in Wind Power 507
APPLICATION 4 The Average Cost of a Music Video 508
APPLICATION 5 The Falling Cost of Solar Power 509
* SUMMARY 509 * KEY TERMS 510 * EXERCISES 510

24 Perfect Competition 514

Preview of the Four Market Structures 515
The Firm’s Short-Run Output Decision 517
  The Total Approach: Computing Total Revenue and Total Cost 517
  The Marginal Approach 518
  Economic Profit and the Break-Even Price 520
The Firm’s Shut-Down Decision 520
  Total Revenue, Variable Cost, and the Shut-Down Decision 520
  The Shut-Down Price 522
  Fixed Costs and Sunk Costs 522
APPLICATION 1 The Break-Even Price for Switchgrass, a Feedstock for Biofuel 523
Short-Run Supply Curves 523
  The Firm’s Short-Run Supply Curve 523
  The Short-Run Market Supply Curve 524
  Market Equilibrium 524
APPLICATION 2 Wireless Women in Pakistan 525
The Long-Run Supply Curve for an Increasing-Cost Industry 526
Production Cost and Industry Size 526
Drawing the Long-Run Market Supply Curve 527
Examples of Increasing-Cost Industries: Sugar and Apartments 528
APPLICATION 3 Wolfram Miners Obey the Law of Supply 528
APPLICATION 4 The Worldwide Supply of Copper 529
Short-Run and Long-Run Effects of Changes in Demand 529
The Short-Run Response to an Increase in Demand 529
The Long-Run Response to an Increase in Demand 529
APPLICATION 5 Planning Controls and Housing Cycles in Britain 531
Long-Run Supply for a Constant-Cost Industry 531
Long-Run Supply Curve for a Constant-Cost Industry 531
Hurricane Andrew and the Price of Ice 532
* SUMMARY 533  * KEY TERMS 533
* EXERCISES 533

25 Monopoly and Price Discrimination 538
The Monopolist's Output Decision 539
Total Revenue and Marginal Revenue 540
A Formula for Marginal Revenue 541
Using the Marginal Principle 542
The Social Cost of Monopoly 544
Deadweight Loss from Monopoly 544
Rent Seeking: Using Resources to Get Monopoly Power 546
APPLICATION 1 A Casino Monopoly in Creswell, Oregon? 547
Monopoly and Public Policy 547
Patents and Monopoly Power 547
Incentives for Innovation 547
Trade-Offs from Patents 548
APPLICATION 2 Bribing the Makers of Generic Drugs 548
Price Discrimination 549
Senior Discounts in Restaurants 550
Price Discrimination and the Elasticity of Demand 551
Examples: Movie Admission versus Popcorn, and Hardback versus Paperback Books 551
APPLICATION 3 Paying for a Cold Soft Drink on a Hot Day 552
APPLICATION 4 Radiohead Lets Consumers Pick the Price 552
* SUMMARY 553  * KEY TERMS 553
* EXERCISES 553
* ECONOMIC EXPERIMENT 557

26 Market Entry and Monopolistic Competition 558
The Effects of Market Entry 559
Entry Squeezes Profits from Three Sides 560
APPLICATION 1 Name Brands versus Store Brands 561
Examples of Entry: Car Stereos, Trucking, and Tires 562
Monopolistic Competition 562
When Entry Stops: Long-Run Equilibrium 563
Differentiation by Location 563
APPLICATION 2 Opening a Dunkin’ Donuts Shop 565
Trade-Offs with Entry and Monopolistic Competition 565
Average Cost and Variety 566
Monopolistic Competition versus Perfect Competition 566
APPLICATION 3 C3PO and Entry in the Market for Space Flight 567
Advertising for Product Differentiation 568
APPLICATION 4 Advertising and Movie Buzz 568
Celebrity Endorsements and Signaling 569
* SUMMARY 570 * KEY TERMS 570
* EXERCISES 570
* ECONOMIC EXPERIMENT 572

27 Oligopoly and Strategic Behavior 574
What Is an Oligopoly? 575
Cartel Pricing and the Duopolists’ Dilemma 576
Price Fixing and the Game Tree 578
Equilibrium of the Price-Fixing Game 579
Nash Equilibrium 580
Overcoming the Duopolists’ Dilemma 580
Low-Price Guarantees 580
Repeated Pricing Games with Retaliation for Underpricing 582
Price Fixing and the Law 583
APPLICATION 1 Marine Hose Conspirators Go to Prison 583
Alternative Models of Oligopoly Pricing 584
Price Leadership 584
The Kinked Demand Curve Model 584
Simultaneous Decision Making and the Payoff Matrix 585
Simultaneous Price-Fixing Game 586
The Prisoners’ Dilemma 586
APPLICATION 2 Cheating On the Final Exam: The Cheaters’ Dilemma 587
The Insecure Monopolist and Entry Deterrence 588
The Passive Approach 588
Entry Deterrence and Limit Pricing 589
Examples: Microsoft Windows, Aluminum, and Campus Bookstores 590
Entry Deterrence and Contestable Markets 591
When Is the Passive Approach Better? 591
APPLICATION 3 Merck and Pfizer Go Generic? 591
The Advertisers’ Dilemma 592
APPLICATION 4 Got Milk? 594
* SUMMARY 594 * KEY TERMS 594
* EXERCISES 595
* ECONOMIC EXPERIMENT 599
28 Controlling Market Power: Antitrust and Regulation 601

Natural Monopoly 602
   Picking an Output Level 602
   Will a Second Firm Enter? 603
   Price Controls for a Natural Monopoly 603
APPLICATION 1 Public versus Private Waterworks 605
APPLICATION 2 Satellite Radio As a Natural Monopoly 605

Antitrust Policy 606
   Breaking Up Monopolies 606
   Blocking Mergers 607
   Merger Remedy for Wonder® Bread 608
   Regulating Business Practices: Price-Fixing, Tying, and Cooperative Agreements 609

The Microsoft Cases 610
   A Brief History of U.S. Antitrust Policy 610
APPLICATION 3 Heinz and Beech-Nut Battle for Second Place 611
APPLICATION 4 Xidex Recovers Its Acquisition Cost in Two Years 611

Deregulation: Airlines, Telecommunications, and Electricity 612
   Deregulation of Airlines 612
   Deregulation of Telecommunication Services 612
   Deregulation of Electricity 613

* SUMMARY 614 * KEY TERMS 614
* EXERCISES 614

PART 10 Externalities and Information

29 Imperfect Information: Adverse Selection and Moral Hazard 617

The Lemons Problem 618
   Uninformed Buyers and Knowledgeable Sellers 618
   Equilibrium with All Low-Quality Goods 619
   A Thin Market: Equilibrium with Some High-Quality Goods 620
   Evidence for the Lemons Problem 622

Responding to the Lemons Problem 622
   Buyers Invest in Information 622
   Consumer Satisfaction Scores from ValueStar and eBay 623
   Guarantees and Lemons Laws 623

Applications of the Lemons Model 624
APPLICATION 1 The Resale Value of a Week-Old Car 624
APPLICATION 2 Regulation of the California Kiwifruit Market 624
APPLICATION 3 Baseball Pitchers Are Like Used Cars 625

Uninformed Sellers and Knowledgeable Buyers: Insurance 626
   Health Insurance 626
   Equilibrium with All High-Cost Consumers 626

Responding to Adverse Selection in Insurance: Group Insurance 628
The Uninsured 628
Other Types of Insurance 629
Insurance and Moral Hazard 629
Insurance Companies and Moral Hazard 630
Deposit Insurance for Savings and Loans 630
Applications: Insurance, Adverse Selection, and Moral Hazard 631
APPLICATION 4 Why Is Car Insurance So Expensive in Philadelphia? 631
APPLICATION 5 Crop Insurance and Adverse Selection 631
APPLICATION 6 Car Insurance and Risky Driving 632
The Economics of Consumer Search 632
Search and the Marginal Principle 632
Reservation Prices and Searching Strategy 634
The Effects of Opportunity Cost and Product Prices on Search Effort 635
* SUMMARY 636 * KEY TERMS 636
* EXERCISES 637
* ECONOMIC EXPERIMENT 641

30 Public Goods and Public Choice 643
External Benefits and Public Goods 646
Public Goods and the Free-Rider Problem 646
Overcoming the Free-Rider Problem 647
Asteroid Diversion as a Public Good 647
APPLICATION 1 Free Riders and the Three-Clock Tower 647
APPLICATION 2 Global Weather Observation 648
Private Goods with External Benefits 648
External Benefits from Education 648
External Benefits and the Marginal Principle 649
Other Private Goods That Generate External Benefits 650
APPLICATION 3 External Benefits from LoJack 650
APPLICATION 4 The Private and External Benefit of Trees 651
Public Choice 651
Voting and the Median-Voter Rule 651
The Median Voter and the Median Location 653
Alternative Models of Government: Self-Interest and Special Interests 654
Which Theory Is Correct? 654
APPLICATION 5 The Median Voter and Support for Public Schools 655
* SUMMARY 656 * KEY TERMS 656
* EXERCISES 656
* ECONOMIC EXPERIMENT 658

31 External Costs and Environmental Policy 660
The Optimal Level of Pollution 661
Using the Marginal Principle 661
Example: The Optimal Level of Water Pollution 662
Coase Bargaining 663
APPLICATION 1 Reducing Methane Emissions 663
Taxing Pollution 664
A Firm's Response to a Pollution Tax 664
PART 11 The Labor Market and Income Distribution

32 The Labor Market, Income, and Poverty 681

The Market Effects of a Pollution Tax 665
Example: A Carbon Tax 667

APPLICATION 2 Pollution Taxes in Rural and Urban Areas 667

Traditional Regulation 668
Uniform Abatement with Permits 668
Command and Control 668
Market Effects of Pollution Regulations 669
Lesson from Dear Abby: Options for Pollution Abatement 669

APPLICATION 3 Mercury in Tuna? 670

 Marketable Pollution Permits 670
Voluntary Exchange and Marketable Permits 670
Supply, Demand, and the Price of Marketable Permits 672

APPLICATION 4 Weather and the Price of Pollution Permits 673

External Costs from Automobiles 673
External Costs from Pollution 673
External Costs from Congestion 675

APPLICATION 5 Young Drivers and Collisions 675
External Costs from Collisions 676

* SUMMARY 676 * KEY TERMS 677
* EXERCISES 677
* ECONOMIC EXPERIMENT 679

Market Demand for Labor in the Short Run 684
Labor Demand in the Long Run 685
Short-Run versus Long-Run Demand 685

The Supply of Labor 685
The Individual Labor-Supply Decision: How Many Hours? 686
An Example of Income and Substitution Effects 686
The Market Supply Curve for Labor 687

APPLICATION 1 Cabbies Respond to an Increase in the Wage 687

Labor Market Equilibrium 688
Changes in Demand and Supply 688
The Market Effects of the Minimum Wage 689

APPLICATION 2 Trade-Offs from Immigration 690

Explaining Differences in Wages and Income 690
Why Do Wages Differ across Occupations? 690
The Gender Pay Gap 691
Racial Discrimination 692
Why Do College Graduates Earn Higher Wages? 693

APPLICATION 3 The Beauty Premium 693

The Distribution of Income 694
Income Distribution Facts 694
Recent Changes in the Distribution of Income 695

Poverty and Public Policy 697
Poverty Rates for Different Groups 697
Redistribution Programs for the Poor 698
33 Unions, Monopsony, and Imperfect Information 705

Labor Unions 706
A Brief History of Labor Unions in the United States 706

Labor Unions and Wages 707
Market Structure and the Wage-Jobs Trade-Off 708
The Effects of Unions on Worker Productivity and Turnover 708

APPLICATION 1 Truckers Trade Off Wages and Jobs 709

APPLICATION 2 What Happened to the High-Aptitude Female Teachers? 710

APPLICATION 3 Pubs and the Labor-Supply Curve 715

Imperfect Information and Efficiency Wages 715
The Mixed Market for Labor 715

APPLICATION 4 Why Do Law Firms Pay More for Janitors and Secretaries? 717

* SUMMARY 718 * KEY TERMS 718 * EXERCISES 718

Glossary 721

Photo Credits 730

Index 732