# Contents

## PART I  INTRODUCTION TO ECONOMICS  40

### Chapter 1: The Principles and Practice of Economics  40

1.1 The Scope of Economics  41
   - Economic Agents and Economic Resources  41
   - Definition of Economics  42
   - Positive Economics and Normative Economics  43
   - Microeconomics and Macroeconomics  44

1.2 Three Principles of Economics  44

1.3 The First Principle of Economics: Optimization  45
   - Trade-offs and Budget Constraints  46
   - Opportunity Cost  46
   - Cost-Benefit Analysis  47
   - Evidence-Based Economics: Is Facebook free?  48

1.4 The Second Principle of Economics: Equilibrium  51
   - The Free-Rider Problem  52

1.5 The Third Principle of Economics: Empiricism  52

1.6 Is Economics Good for You?  53
   - Summary  54
   - Key Terms  54
   - Questions  55
   - Problems  55

### Chapter 2: Economic Methods and Economic Questions  58

2.1 The Scientific Method  59
   - Models and Data  59
   - An Economic Model  61
     - Evidence-Based Economics: How much more do workers with a college education earn?  62
   - Means  63
   - Argument by Anecdote  63

2.2 Causation and Correlation  64
   - The Red Ad Campaign Blues  64
   - Causation versus Correlation  65
   - Experimental Economics and Natural Experiments  66
     - Evidence-Based Economics: How much do wages increase when an individual is compelled by law to get an extra year of schooling?  67

2.3 Economic Questions and Answers  68
   - Summary  70
   - Key Terms  70
   - Questions  70
   - Problems  71

### Appendix: Constructing and Interpreting Graphs  72
   - A Study About Incentives  72
   - Experimental Design  72
   - Describing Variables  73
   - Cause and Effect  75
   - Appendix Key Terms  78
   - Appendix Problems  79

### Chapter 3: Optimization: Doing the Best You Can  80

3.1 Two Kinds of Optimization: A Matter of Focus  81
   - Choice & Consequence: Do People Really Optimize?  83

3.2 Optimization in Levels  84
   - Comparative Statics  86

3.3 Optimization in Differences: Marginal Analysis  88
   - Marginal Cost  88
     - Evidence-Based Economics: How does location affect the rental cost of housing?  91
   - Summary  94
   - Key Terms  94
   - Questions  95
   - Problems  95

### Chapter 4: Demand, Supply, and Equilibrium  98

4.1 Markets  99
   - Competitive Markets  100

4.2 How Do Buyers Behave?  101
   - Demand Curves  102
   - Willingness to Pay  102
   - From Individual Demand Curves to Aggregated Demand Curves  103
   - Building the Market Demand Curve  104
   - Shifting the Demand Curve  105

### Appendix Key Terms  78

### Appendix Problems  79
Evidence-Based Economics: How much more gasoline would people buy if its price were lower? 107

4.3 How Do Sellers Behave?

Supply Curves 109
Willingness to Accept 110
From the Individual Supply Curve to the Market 110
Shifting the Supply Curve 110

4.4 Supply and Demand in Equilibrium 113

Curve Shifting in Competitive Equilibrium 115

4.5 What Would Happen If the Government Tried to Dictate the Price of Gasoline?

Choice & Consequence: The Unintended Consequences of Fixing Market Prices 119

Summary 120
Key Terms 121
Questions 121
Problems 122

PART II FOUNDATIONS OF MICROECONOMICS 124

Chapter 5: Consumers and Incentives 124

5.1 The Buyer's Problem 125
What You Like 125
Prices of Goods and Services 126
Choice & Consequence: Absolutes vs. Percentages 126
How Much Money You Have to Spend 127

5.2 Putting It All Together 128
Price Changes 130
Income Changes 131

5.3 From the Buyer's Problem to the Demand Curve 131

5.4 Consumer Surplus 133
An Empty Feeling: Loss in Consumer Surplus 134
When Price Increases 134
Evidence-Based Economics: Would a smoker quit the habit for $100 per month? 135

5.5 Demand Elasticities 138
The Price Elasticity of Demand 138
Moving Up and Down the Demand Curve 139
Elasticity Measures 140
Determinants of the Price Elasticity of Demand 141
The Cross-Price Elasticity of Demand 143
The Income Elasticity of Demand 143
Letting the Data Speak: Should McDonald's Be Interested in Elasticities? 144

Chapter 6: Sellers and Incentives 152

6.1 Sellers in a Perfectly Competitive Market 153

6.2 The Seller's Problem 153
Making the Goods: How Inputs Are Turned into Outputs 154
The Cost of Doing Business: Introducing Cost Curves 156
Choice & Consequence: Average Cost Versus Marginal Cost 158
The Rewards of Doing Business: Introducing Revenue Curves 158
Putting It All Together: Using the Three Components to Do the Best You Can 160
Choice & Consequence: Maximizing Total Profit, Not Per-Unit Profit 162

6.3 From the Seller's Problem to the Supply Curve 162
Price Elasticity of Supply 163
Shutdown 164

6.4 Producer Surplus 165

6.5 From the Short Run to the Long Run 167
Long-Run Supply Curve 168
Choice & Consequence: Visiting a Car Manufacturing Plant 168

6.6 From the Firm to the Market: Long-Run Competitive Equilibrium 169
Firm Entry 169
Firm Exit 170
Zero Profits in the Long Run 171
Economic Profit versus Accounting Profit 172
Evidence-Based Economics: How would an ethanol subsidy affect ethanol producers? 173

Summary 176
Key Terms 177
Questions 177
Problems 178

Appendix: When Firms Have Different Cost Structures 180
Chapter 7: Perfect Competition and the Invisible Hand 182

7.1 Perfect Competition and Efficiency 183
Social Surplus 184
Pareto Efficiency 186

7.2 Extending the Reach of the Invisible Hand: From the Individual to the Firm 186

7.3 Extending the Reach of the Invisible Hand: Allocation of Resources Across Industries 190

7.4 Prices Guide the Invisible Hand 193
Deadweight Loss 194
The Command Economy 195

Choice & Consequence: FEMA and Walmart After Katrina 196
The Central Planner 197

Choice & Consequence: Command and Control at Kmart 199

7.5 Equity and Efficiency 199

Evidence-Based Economics: Can markets composed of only self-interested people maximize the overall well-being of society? 200

Summary 204
Key Terms 204
Questions 204
Problems 205

Chapter 8: Trade 208

8.1 The Production Possibilities Curve 209
Calculating Opportunity Cost 211

8.2 The Basis for Trade: Comparative Advantage 212
Specialization 213
Absolute Advantage 213

Choice & Consequence: An Experiment on Comparative Advantage 214
The Price of the Trade 215

8.3 Trade Between States 216

Choice & Consequence: Should LeBron James Paint His Own House? 217

Economy-Wide PPC 217
Comparative Advantage and Specialization Among States 219

8.4 Trade Between Countries 220
Determinants of Trade Between Countries 222

Letting the Data Speak: Fair Trade Products 223
Exporting Nations: Winners and Losers 223
Importing Nations: Winners and Losers 224
Where Do World Prices Come From? 225
Determinants of a Country’s Comparative Advantage 225

8.5 Arguments Against Free Trade 226
National Security Concerns 226
Fear of Globalization 226
Environmental and Resource Concerns 226
Infant Industry Arguments 227
The Effects of Tariffs 227

Evidence-Based Economics: Will free trade cause you to lose your job? 229

Summary 231
Key Terms 231
Questions 232
Problems 232

Chapter 9: Externalities and Public Goods 236

9.1 Externalities 237
A “Broken” Invisible Hand: Negative Externalities 238
A “Broken” Invisible Hand: Positive Externalities 240

Choice & Consequence: Positive Externalities in Spots You Never Imagined 242
Pecuniary Externalities 243

9.2 Private Solutions to Externalities 243
Private Solution: Bargaining 244
The Coase Theorem 244
Private Solution: Doing the Right Thing 245

9.3 Government Solutions to Externalities 246
Government Regulation: Command-and-Control Policies 246
Government Regulation: Market-Based Approaches 247
Corrective Taxes and Subsidies 247

Letting the Data Speak: How To Value Externalities 248
Letting the Data Speak: Pay As You Throw: Consumers Create Negative Externalities Too! 249

9.4 Public Goods 250
Government Provision of Public Goods 251

Choice & Consequence: The Free-Rider’s Dilemma 252
Private Provision of Public Goods 254

9.5 Common Pool Resource Goods 256

Choice & Consequence: Tragedy of the Commons 257
Choice & Consequence: The Race to Fish 257

Evidence-Based Economics: How can the Queen of England lower her commute time to Wembley Stadium? 258

Summary 260
Key Terms 260
Questions 260
Problems 261
Chapter 13: Game Theory and Strategic Play

13.1 Simultaneous Move Games
- Best Responses and the Prisoners’ Dilemma
- Dominant Strategies and Equilibrium
- Games without Dominant Strategies

13.2 Nash Equilibrium
- Finding a Nash Equilibrium
- Choice & Consequence: Work or Surf?

13.3 Applications of Nash Equilibria
- Tragedy of the Commons Revisited
- Zero-Sum Games

13.4 How Do People Actually Play Such Games?
- Game Theory in Penalty Kicks

13.5 Extensive-Form Games
- Backward Induction
- First-Mover Advantage, Commitment, and Vengeance
- Evidence-Based Economics: Is there value in putting yourself into someone else's shoes?
- Choice & Consequence: There is More to Life than Money

Summary
Key Terms
Questions
Problems

Chapter 14: Oligopoly and Monopolistic Competition

14.1 Two More Market Structures

14.2 Oligopoly
- The Oligopolist’s Problem
- Oligopoly Model with Homogeneous Products
- Doing the Best You Can: How Should You Price to Maximize Profits?
- Oligopoly Model with Differentiated Products
- Letting the Data Speak: Airline Price Wars
- Collusion: One Way to Keep Prices High
- Letting the Data Speak: To Cheat or Not to Cheat: That is the Question
- Choice & Consequence: Collusion in Practice

14.3 Monopolistic Competition
- The Monopolistic Competitor’s Problem
- Doing the Best You Can: How a Monopolistic Competitor Maximizes Profits
- Letting the Data Speak: Why Do Some Firms Advertise and Some Don’t?
- How a Monopolistic Competitor Calculates Profits

Summary
Key Terms
Questions
Problems

PART IV EXTENDING THE MICROECONOMIC TOOLBOX

Chapter 15: Trade-offs Involving Time and Risk

15.1 Modeling Time and Risk

15.2 The Time Value of Money
- Future Value and the Compounding of Interest
- Borrowing Versus Lending
- Present Value and Discounting

15.3 Time Preferences
- Time Discounting
- Preference Reversals
- Choice & Consequence: Failing to Anticipate Preference Reversals
- Evidence-Based Economics: Do people exhibit a preference for immediate gratification?

15.4 Probability and Risk
- Roulette Wheels and Probabilities
- Independence and the Gambler’s Fallacy
- Expected Value
- Choice & Consequence: Is Gambling Worthwhile?
- Extended Warranties

15.5 Risk Preferences
- Summary
- Key Terms
- Questions
- Problems

Chapter 16: The Economics of Information

16.1 Asymmetric Information
- Hidden Characteristics: Adverse Selection in the Used Car Market
- Hidden Characteristics: Adverse Selection in the Health Insurance Market
Market Solutions to Adverse Selection:
Signaling
Choice & Consequence: Are You Sending a Signal Right Now?
Evidence-Based Economics: Why do new cars lose considerable value the minute they are driven off the lot?
Choice & Consequence: A Tale of a Tail

16.2 Hidden Actions: Markets with Moral Hazard
Letting the Data Speak: Moral Hazard on Your Bike
Market Solutions to Moral Hazard in the Labor Market: Efficiency Wages
Market Solutions to Moral Hazard in the Insurance Market: “Putting Your Skin in the Game”
Letting the Data Speak: Designing Incentives for Teachers
Evidence-Based Economics: Why is private health insurance so expensive?

16.3 Government Policy in a World of Asymmetric Information
Government Intervention and Moral Hazard
The Equity-Efficiency Trade-off
Crime and Punishment as a Principal–Agent Problem
Letting the Data Speak: Moral Hazard Among Job Seekers
Summary
Key Terms
Questions
Problems

Chapter 17: Auctions and Bargaining

17.1 Auctions
Types of Auctions
Open-Outcry English Auctions
Letting the Data Speak: To Snipe or Not to Snipe?
Open-Outcry Dutch Auctions
Sealed Bid: First-Price Auction
Sealed Bid: Second-Price Auction
The Revenue Equivalence Theorem
Evidence-Based Economics: How should you bid in an eBay auction?

17.2 Bargaining
What Determines Bargaining Outcomes?
Bargaining in Action: The Ultimatum Game
Bargaining and the Coase Theorem
Evidence-Based Economics: Who determines how the household spends its money?

Letting the Data Speak: Sex Ratios Change
Summary
Key Terms
Questions
Problems

Chapter 18: Social Economics

18.1 The Economics of Charity and Fairness
The Economics of Charity
Letting the Data Speak: Do People Donate Less When It’s Costlier to Give?
Letting the Data Speak: Why Do People Give to Charity?
The Economics of Fairness
Letting the Data Speak: Dictators in the Lab
Evidence-Based Economics: Do people care about fairness?

18.2 The Economics of Trust and Revenge
The Economics of Trust
The Economics of Revenge
Choice & Consequence: Does Revenge Have an Evolutionary Logic?

18.3 How Others Influence Our Decisions
Where Do Our Preferences Come From?
The Economics of Peer Effects
Letting the Data Speak: Is Economics Bad for You?
Following the Crowd: Herding
Letting the Data Speak: Your Peers Affect Your Waistline
Choice & Consequence: Are You an Internet Explorer?
Summary
Key Terms
Questions
Problems

PART V Introduction to Macroeconomics

Chapter 19: The Wealth of Nations: Defining and Measuring Macroeconomic Aggregates

19.1 Macroeconomic Questions
19.2 National Income Accounts: Production = Expenditure = Income
Production
Expenditure
Income
19.3 What Isn't Measured by GDP? 477

19.4 Real vs. Nominal 482

Chapter 20: Aggregate Incomes 492

20.1 Inequality Around the World 493

20.2 Productivity and the Aggregate Production Function 500

20.3 The Role and Determinants of Technology 504

Chapter 21: Economic Growth 516

21.1 The Power of Economic Growth 517

21.2 How Does a Nation’s Economy Grow? 525

21.3 The History of Growth and Technology 531

21.4 Growth, Inequality, and Poverty 533

Appendix: The Mathematics of Aggregate Production Functions 514
Chapter 25: The Monetary System

25.1 Money
The Functions of Money
Types of Money
The Money Supply
Choice & Consequence: Non-Convertible Currencies in U.S. History

25.2 Money, Prices, and GDP
Nominal GDP, Real GDP, and Inflation
The Quantity Theory of Money

25.3 Inflation
What Causes Inflation?
The Consequences of Inflation
The Social Costs of Inflation
The Social Benefits of Inflation
Evidence-Based Economics: What caused the German hyperinflation of 1922–1923?

25.4 The Federal Reserve
The Central Bank and the Objectives of Monetary Policy
What Does the Central Bank Do?
Bank Reserves
The Demand Side of the Federal Funds Market
The Supply Side of the Federal Funds Market and Equilibrium in the Federal Funds Market
The Fed’s Influence on the Money Supply and the Inflation Rate
Choice & Consequence: Obtaining Reserves Outside the Federal Funds Market
The Relationship Between the Federal Funds Rate and the Long-Term Real Interest Rate
Choice & Consequence: Two Models of Inflation Expectations

26.2 Macroeconomic Equilibrium and Economic Fluctuations
Labor Demand and Fluctuations
Sources of Fluctuations

Letting the Data Speak: Unemployment and the Growth Rate of Real GDP: Okun’s Law
Multiplier and Economic Fluctuations
Equilibrium in the Short Run, with Multipliers and Downward Wage Rigidity
Equilibrium in the Medium Run: Partial Recovery and Full Recovery

26.3 Modeling Expansions
Evidence-Based Economics: What caused the recession of 2007–2009?
Summary
Key Terms
Questions
Problems

Chapter 26: Short-Run Fluctuations

26.1 Economic Fluctuations and Business Cycles
Patterns of Economic Fluctuations
The Great Depression

Evidence-Based Economics: What caused the German hyperinflation of 1922–1923?

Chapter 27: Countercyclical Macroeconomic Policy

27.1 The Role of Countercyclical Policies in Economic Fluctuations
Countercyclical Monetary Policy
Controlling the Federal Funds Rate
Other Tools of the Fed
Expectations, Inflation, and Monetary Policy

Letting the Data Speak: Managing Expectations
Contractionary Monetary Policy: Control of Inflation
Zero Lower Bound
Choice & Consequence: Policy Mistakes
Policy Trade-offs

27.2 Countercyclical Fiscal Policy
Fiscal Policy Over the Business Cycle: Automatic and Discretionary Components
Analysis of Expenditure-Based Fiscal Policy
Analysis of Taxation-Based Fiscal Policy
Fiscal Policies that Directly Target the Labor Market
Policy Waste and Policy Lags
Evidence-Based Economics: How much does government expenditure stimulate GDP?

27.3 Policies That Blur the Line Between Fiscal and Monetary Policy
Fiscal and Monetary Policy
Summary
Key Terms
Questions
Problems

PART VIII Short-Run Fluctuations and Macroeconomic Policy

Chapter 26: Short-Run Fluctuations

26.1 Economic Fluctuations and Business Cycles
Patterns of Economic Fluctuations
The Great Depression