# Short contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>List of figures</td>
<td>xvii</td>
</tr>
<tr>
<td>List of tables</td>
<td>xxi</td>
</tr>
<tr>
<td>Preface</td>
<td>xxi</td>
</tr>
<tr>
<td>Video lectures and suggested uses</td>
<td>xxxiii</td>
</tr>
<tr>
<td>How to use this book in traditional, online, and hybrid courses</td>
<td>xxxvi</td>
</tr>
<tr>
<td><strong>Book I</strong> The market economy, overview and application</td>
<td>1</td>
</tr>
<tr>
<td>1 Microeconomics: a way of thinking about business</td>
<td>3</td>
</tr>
<tr>
<td>2 Principles of rational behavior in society and business</td>
<td>51</td>
</tr>
<tr>
<td>3 Competitive product markets and firm decisions</td>
<td>97</td>
</tr>
<tr>
<td>4 Applications of the economic way of thinking: domestic government and management policies</td>
<td>149</td>
</tr>
<tr>
<td><strong>Book II</strong> Applications of basic economic theory</td>
<td>199</td>
</tr>
<tr>
<td>5 Applications of the economic way of thinking: international economics</td>
<td>201</td>
</tr>
<tr>
<td>6 Applications of the economic way of thinking: environmental economics</td>
<td>232</td>
</tr>
<tr>
<td><strong>Book III</strong> Demand and production theory</td>
<td>267</td>
</tr>
<tr>
<td>7 Consumer choice and demand in traditional and network markets</td>
<td>269</td>
</tr>
<tr>
<td>8 Production costs and the theory of the firm</td>
<td>310</td>
</tr>
<tr>
<td>9 Production costs in the short run and long run</td>
<td>360</td>
</tr>
<tr>
<td><strong>Book IV</strong> Competitive and monopoly market structures</td>
<td>403</td>
</tr>
<tr>
<td>10 Firm production under idealized competitive conditions</td>
<td>405</td>
</tr>
<tr>
<td>11 Monopoly power and firm pricing decisions</td>
<td>450</td>
</tr>
<tr>
<td>12 Firm strategy under imperfectly competitive market conditions</td>
<td>502</td>
</tr>
<tr>
<td>13 Competitive and monopsonistic labor markets</td>
<td>549</td>
</tr>
</tbody>
</table>
vi Short contents

Book V Behavioral economics: a challenge to conventional microeconomics 597
14 Challenges of behavioral economists 599
15 Problems with behavioral economics 632

Bibliography 676
Index 707
Contents

List of figures page xviii
List of tables xxi
Preface xxiii
Video lectures and suggested uses xxxiii
How to use this book in traditional, online, and hybrid courses xxxvi

Book I The market economy, overview and application 1

1 Microeconomics: a way of thinking about business 3

Part A Theory and public policy applications 8
The emergence of a market 8
The economic problem 10
The scope of economics 13
Developing and using economic theories 14
Microeconomics and macroeconomics 16
Private property rights, game theory, and the Prisoner’s Dilemma 17
Private property rights and the games economists play 18
Private property rights and the market 19
The emergence of private property rights 20
Game theory: Prisoner’s Dilemmas 23
Prisoner’s Dilemma solutions: enforcement and trade 24
Communal property rights and the “tragedy of the commons” 27
Voluntary organizations and firms as solutions for “tragedies of the commons” 32
The tragedy of the anticommons 33
Perspective 1 “I, Pencil,” by Leonard E. Read 36

Part B Organizational economics and management 40
Managing through incentives 40
Productivity increases 41
The growing importance of incentives 42
The classic Lincoln Electric case study 42
Contents

2 Principles of rational behavior in society and business 51

Part A Theory and public policy applications 53

Rationality: a basis for exploring human behavior 54
Rational decisions in a constrained environment 57
Maximizing satisfaction; cost–benefit analysis 60
The effects of time and risk on costs and benefits 62
What rational behavior does not mean 66
Perspective 2 The evolutionary foundations of cooperation 68

Part B Organizational economics and management 72

The logic of group behavior in business and elsewhere 72
The common-interest logic of group behavior 72
The economic logic of group behavior 74
Overcoming Prisoner’s Dilemmas through tough bosses 83
Take this job and ... 84
The role of the residual claimant in abating Prisoner’s Dilemmas in large groups 90

Practical lessons for serious business students 93
Further reading online 93
Recommended video lectures 93
The bottom line 94
Review questions 95

3 Competitive product markets and firm decisions 97

Part A Theory and public policy applications 99
The competitive market process 99
Supply and demand: a market model 102
Market equilibrium 111
The efficiency of the competitive market model 116
Nonprice competition 118
Competitive labor markets 124
Perspective 3 Why queues? 126

Part B Organizational economics and management 130
Making worker wages profitable in competitive markets 130
Henry Ford’s “overpayment” 130
Overpayments to prevent misuse of firm resources 134
The underpayment and overpayment of workers 135
The overpayment/underpayment connection 136
Mandatory retirement 136
The role of employers’ “credible commitments” 139
Practical lessons for serious business students 145
Further reading online 146
Recommended video lectures 146
The bottom line 146
Review questions 147

4 Applications of the economic way of thinking: domestic government and management policies 149

Part A Theory and public policy applications 150
Who pays the tax? 150
Price controls 153
The California drought and the effects of low and controlled water prices on conservation 157
Fringe benefits, incentives, and profits 161
Minimum wages 168
The draft versus the all-volunteer military service 176
Perspective 4 Maslow’s Hierarchy of Needs and economists’ supply and demand curves, contrasting views on human (and economic) choices 178

Part B Organizational economics and management 185
How honesty can pay in business 186
Game theory, again: games of trust 188
Moral hazards and adverse selection 190
The role of “hostages” in business 192
Firm logos 192
Storefronts and fixtures 193
Firm profitability 193
Creation of competition 193
Joint ownership 194
Guarantees 195
Practical lessons for serious business students 195
Further reading online 196
Recommended video lectures 196
The bottom line 196
Review questions 197

Book II  Applications of basic economic theory 199

5 Applications of the economic way of thinking:
international economics 201

Part A  International trade theory and public policy applications 203
Global economics: international trade 203
Aggregate gains from trade 203
The law of comparative advantage 205
The distributional effects of trade 208
Gains to exporters 209
The effects of trade restrictions 210
Special interests’ politics and trade restrictions 211
Protection retaliation and trade wars 212
Interconnections of comparative advantage 214
The Trade Authority Bill 2015 215

Perspective 5  “A PETITION From the Manufacturers of Candles, … and Generally of Everything Connected with Lighting,”
by Frédéric Bastiat (1801–1850), Sophismes économiques, 1845 216

Part B  International finance 219
The process of international monetary exchange 220
The exchange of national currencies 221
Determination of the exchange rate 223
Exchange rates and changes in domestic market conditions 225
Monetary and fiscal policies 227
Practical lessons for serious business students 229
Further reading online 229
Recommended video lectures 230
The bottom line 230
Review questions 230
Contents

6 Applications of the economic way of thinking: environmental economics 232

Part A Green economics: external costs and benefits 233

Competitive markets and environmental failures 234
External costs 235
External benefits 238
The pros and cons of government action 240
Methods of reducing externalities 241
Choosing the most efficient remedy for reducing external costs of pollution 245

Perspective 6 Why walking to work can be more polluting than driving to work 248

Part B Organizational economics and management 253

The consequences of “quicksilver capital” for business and government 253
Capital mobility and business competitiveness 255
Capital mobility and government competitiveness 255
Collective agreement problems in averting global-warming Armageddon 258

Practical lessons for serious business students 263
Further reading online 264
Recommended video lectures 264
The bottom line 264
Review questions 265

Book III Demand and production theory 267

7 Consumer choice and demand in traditional and network markets 269

Part A Theory and public policy applications 270

Predicting consumer demand 270
Rational consumption: the concept of marginal utility 271
Changes in price and the law of demand 274
From individual demand to market demand 276
Elasticity: consumers’ responsiveness to price changes 277
Applications of the concept of elasticity 282
Determinants of the price elasticity of demand 285
Changes in demand 286
Normal and inferior goods 288
8 Production costs and the theory of the firm

Part A Theory and public policy applications

Various cost conceptions
The special significance of marginal cost
The cost-benefit trade-off
Price and marginal cost: producing to maximize profits
From individual supply to market supply
Perspective 8 The last-period problem

Part B Organizational economics and management

Production costs and firms' size and organizational structure
Reasons for firms
Changes in organizational costs
Overcoming the large-numbers' Prisoner's Dilemma problems
Make-or-buy decisions
The value of reputation, again
The franchise decision

Practical lessons for serious business students
Further reading online
Recommended video lectures
The bottom line
Review questions
9 Production costs in the short run and long run 360

Part A Theory and public policy applications 362

Fixed, variable, and total costs in the short run 362
Marginal and average costs in the short run 363
Marginal and average costs in the long run 366
Long-run average and marginal cost curves 368
Industry differences in average cost 368
Shifts in the average and marginal cost curves 371
The very long run 372

Perspective 9 Myth of the first-mover advantage 373

Part B Organizational economics and management 376

Firms’ debt/equity structures and executive incentives 376
Debt and equity as alternative investment vehicles 378
Past failed incentives in the S&L industry 380
Industry maturity and funds misuse 383
Firm maturity and indebtedness 385
The bottom-line consequences of firms’ financial structures 385
The emergence of the housing bubble and burst of the early 2000s 386
The bailout and stimulus policy debate, for and against 395
Lessons learned from the housing and economic crisis? 397

Practical lessons for serious business students 399
Further reading online 399
Recommended video lecture 399
The bottom line 400
Review questions 401

Book IV Competitive and monopoly market structures 403

10 Firm production under idealized competitive conditions 405

Part A Theory and public policy applications 406

Pricing and production strategies under four market structures 407
The perfect competitor’s production decision 411
Maximizing short-run profits 414
Minimizing short-run losses 416
## Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Producing over the long run</td>
<td>418</td>
</tr>
<tr>
<td>Marginal benefit versus marginal cost</td>
<td>421</td>
</tr>
<tr>
<td>The efficiency of perfect competition: a critique</td>
<td>423</td>
</tr>
<tr>
<td>Price takers and price searchers</td>
<td>426</td>
</tr>
<tr>
<td>The perfection in perfect competition?</td>
<td>428</td>
</tr>
<tr>
<td><strong>Perspective 10</strong> The “innovator’s dilemma”</td>
<td>430</td>
</tr>
<tr>
<td><strong>Part B</strong> Organizational economics and management</td>
<td>436</td>
</tr>
<tr>
<td>Competing cost-effectively through efficient teams</td>
<td>436</td>
</tr>
<tr>
<td>Team production</td>
<td>437</td>
</tr>
<tr>
<td>Paying teams</td>
<td>441</td>
</tr>
<tr>
<td>Experimental evidence on the effectiveness of team pay</td>
<td>443</td>
</tr>
<tr>
<td>Practical lessons for serious business students</td>
<td>445</td>
</tr>
<tr>
<td>Further reading online</td>
<td>447</td>
</tr>
<tr>
<td>Recommended video lectures</td>
<td>447</td>
</tr>
<tr>
<td>The bottom line</td>
<td>447</td>
</tr>
<tr>
<td>Review questions</td>
<td>448</td>
</tr>
</tbody>
</table>

### 11 Monopoly power and firm pricing decisions

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Part A</strong> Theory and public policy applications</td>
<td>450</td>
</tr>
<tr>
<td>The origins of monopoly</td>
<td>452</td>
</tr>
<tr>
<td>The limits of monopoly power</td>
<td>454</td>
</tr>
<tr>
<td>Equating marginal cost with marginal revenue</td>
<td>458</td>
</tr>
<tr>
<td>The comparative inefficiency of monopoly</td>
<td>461</td>
</tr>
<tr>
<td>Monopoly profits</td>
<td>463</td>
</tr>
<tr>
<td>Price discrimination</td>
<td>465</td>
</tr>
<tr>
<td>Applications of monopoly theory</td>
<td>470</td>
</tr>
<tr>
<td>The total cost of monopoly</td>
<td>472</td>
</tr>
<tr>
<td>Durable goods monopoly</td>
<td>475</td>
</tr>
<tr>
<td>Monopoly in government and inside firms</td>
<td>476</td>
</tr>
<tr>
<td><strong>Perspective 11</strong> The QWERTY keyboard: a case of “lock-in”?</td>
<td>478</td>
</tr>
<tr>
<td><strong>Part B</strong> Organizational economics and management</td>
<td>481</td>
</tr>
<tr>
<td>Profits from creative pricing</td>
<td>481</td>
</tr>
<tr>
<td>Price discrimination in practice</td>
<td>481</td>
</tr>
<tr>
<td>Pricing cartels</td>
<td>487</td>
</tr>
<tr>
<td>Practical lessons for serious business students</td>
<td>493</td>
</tr>
<tr>
<td>Further reading online</td>
<td>494</td>
</tr>
<tr>
<td>Recommended video lectures</td>
<td>494</td>
</tr>
</tbody>
</table>
12 Firm strategy under imperfectly competitive market conditions 502

Part A Theory and public policy applications 504

Monopolistic competition 505
Oligopoly 509
Cartels: incentives to collude and to cheat 513
Game theory: cartels and the Nash equilibrium 515
The case of the natural monopoly 518
The economics and politics of business regulation 520
Perspective 12 Pedophiles and the regulation of hugging, with Kathryn Shelton 526

Part B Organizational economics and management 533

“Hostile” takeover as a check on managerial monopolies 533
Reasons for takeovers 534
The market for corporate control 534
The efficiency of takeovers 537
Will monopoly profits last into the very long run? 543

Practical lessons for serious business students 544
Further reading online 546
Recommended video lectures 546
The bottom line 546
Review questions 547

13 Competitive and monopsonistic labor markets 549

Part A Theory and public policy applications 551

The demand for and supply of labor 551
Why wage rates differ 557
Overtime pay, an unmitigated benefit for covered workers? 562
Monopsonistic labor markets 563
Employer cartels: monopsony power through collusion 568
Monopsony and the minimum wage 569
Perspective 13 Why professors have tenure and businesspeople don’t 570
### Part B Organizational economics and management

- Paying for performance  
- When managers can change the rate of piece-rate pay  
- Two-part pay systems  
- Why incentive pay equals higher pay  
- One-time bonuses versus annual raises

**Practical lessons for serious business students**  
Further reading online  
Recommended video lectures  
The bottom line  
Review questions

### Book V Behavioral economics: a challenge to conventional microeconomics

#### 14 Challenges of behavioral economists

- **Part A** The overall dimensions of the behavioral challenge  
  - Prospect theory  
  - Dominance and invariance  
  - Mental accounting  
  - Endowment effect  
  - Acquisition and transaction utility  
  - The matter of sunk costs  
  - Perspective 14 Neuroeconomics, by Paul J. Zak

- **Part B** Behavioral finance  
  - The efficient-market hypothesis, again  
  - Behaviorists' objections to conventional finance theory

Further reading online  
The bottom line  
Review questions

#### 15 Problems with behavioral economics

- **Part A** Concerns with basic principles of behavioral economics  
  - The perfect rationality caricature  
  - Reliance on constrained laboratory studies
Contents  

The human brain’s internal inclination to correct errant decisions 642  
Ecologically adaptive environments 645  
Subjects’ overall rationality 646  
Errant decisions, entrepreneurs, and market pressures 650  
The rational emergence of choice options 655  
Perspective 15 NBC’s anchor Brian Williams’ fall from grace, “false memory,” and incentives 656  

Part B “Nudges” and their problems 661  
Proposed nudges 661  
Problems with nudges 666  
From nudges to mandates: the slippery slope 670  

Further reading online 673  
Recommended video lecture 673  
The bottom line 673  
Review questions 675  

Bibliography 676  
Index 707