CONTENTS

Preface

1 The Market

Constructing a Model 1 Optimization and Equilibrium 3 The Demand Curve 3 The Supply Curve 5 Market Equilibrium 7 Comparative Statics 9 Other Ways to Allocate Apartments 11 The Discriminating Monopolist • The Ordinary Monopolist • Rent Control • Which Way Is Best? 14 Pareto Efficiency 15 Comparing Ways to Allocate Apartments 16 Equilibrium in the Long Run 17 Summary 18 Review Questions 19

2 Budget Constraint

The Budget Constraint 20 Two Goods Are Often Enough 21 Properties of the Budget Set 22 How the Budget Line Changes 24 The Numeraire 26 Taxes, Subsidies, and Rationing 26 Example: The Food Stamp Program Budget Line Changes 31 Summary 31 Review Questions 32

xix

3 Preferences

Consumer Preferences 34 Assumptions about Preferences 35 Indifference Curves 36 Examples of Preferences 37 Perfect Substitutes
Perfect Complements • Bads • Neutrals • Satiation • Discrete Goods • Well-Behaved Preferences 44 The Marginal Rate of Substitution 48 Other Interpretations of the MRS 50 Behavior of the MRS 51 Summary 52 Review Questions 52

4 Utility

Cardinal Utility 57 Constructing a Utility Function 58 Some Examples of Utility Functions 59 Example: Indifference Curves from Utility Perfect Substitutes • Perfect Complements • Quasilinear Preferences
• Cobb-Douglas Preferences • Marginal Utility 65 Marginal Utility and MRS 66 Utility for Commuting 67 Summary 69 Review Questions 70 Appendix 70 Example: Cobb-Douglas Preferences

5 Choice

Optimal Choice 73 Consumer Demand 78 Some Examples 78
Perfect Substitutes • Perfect Complements • Neutrals and Bads •
Discrete Goods • Concave Preferences • Cobb-Douglas Preferences •
Estimating Utility Functions 83 Implications of the MRS Condition 85
Choosing Taxes 87 Summary 89 Review Questions 89 Appendix 90 Example: Cobb-Douglas Demand Functions

6 Demand

Normal and Inferior Goods 96 Income Offer Curves and Engel Curves
97 Some Examples 99 Perfect Substitutes • Perfect Complements
• Cobb-Douglas Preferences • Homothetic Preferences • Quasilinear Preferences • Ordinary Goods and Giffen Goods 104 The Price Offer Curve and the Demand Curve 106 Some Examples 107 Perfect Substitutes • Perfect Complements • A Discrete Good • Substitutes and Complements 111 The Inverse Demand Function 112 Summary 114 Review Questions 115 Appendix 115

7 Revealed Preference

The Idea of Revealed Preference 119 From Revealed Preference to Preference 120 Recovering Preferences 122 The Weak Axiom of Revealed Preference 124 Checking WARP 125 The Strong Axiom of Revealed Preference 128 How to Check SARP 129 Index Numbers 130 Price Indices 132 *Example: Indexing Social Security Payments* Summary 135 Review Questions 135

8 Slutsky Equation

The Substitution Effect137Example: Calculating the Substitution EffectfectThe Income Effect141Example: Calculating the Income EffectSign of the Substitution Effect142The Total Change in Demand143Rates of Change144The Law of Demand147Examples of Incomeand Substitution Effects147Example: Rebating a TaxExample:Voluntary Real Time PricingAnother Substitution Effect153Compensated Demand Curvespensated Demand Curves155Summary156Review Questions157Appendix157Example: Rebating a Small TaxSmall Tax

9 Buying and Selling

Net and Gross Demands 160 The Budget Constraint 161 Changing the Endowment 163 Price Changes 164 Offer Curves and Demand Curves 167 The Slutsky Equation Revisited 168 Use of the Slutsky Equation 172 Example: Calculating the Endowment Income Effect Labor Supply 173 The Budget Constraint • Comparative Statics of Labor Supply 174 Example: Overtime and the Supply of Labor Summary 178 Review Questions 179 Appendix 179

X CONTENTS

10 Intertemporal Choice

The Budget Constraint 182 Preferences for Consumption 185 Com-The Slutsky Equation and Intertemporal Choice parative Statics 186 187 Inflation 189 Present Value: A Closer Look 191 Analyzing Present Value for Several Periods 193 Use of Present Value 194 Example: Valuing a Stream of Payments Example: The True Cost of a Credit Card Example: Extending Copyright Bonds 198 Example: Installment Loans Taxes 200 Example: Scholarships and Savings Choice of the Interest Rate 201 Summary 202 Review Questions 202

11 Asset Markets

Rates of Return 203 Arbitrage and Present Value 205 Adjustments
for Differences among Assets 205 Assets with Consumption Returns
206 Taxation of Asset Returns 207 Market Bubbles 208 Applications 209 Depletable Resources • When to Cut a Forest • Example:
Gasoline Prices during the Gulf War Financial Institutions 213 Summary 214 Review Questions 215 Appendix 215

12 Uncertainty

Contingent Consumption**217**Example: Catastrophe BondsUtilityFunctions and Probabilities**222**Example: Some Examples of UtilityFunctionsExpected Utility**223**Why Expected Utility Is Reasonable**224**Risk Aversion**226**Example: The Demand for Insurance Di-versification**230**Risk Spreading**230**Role of the Stock Market**231**Summary**232**Review Questions**232**The Effect of Taxation on Investment in Risky Assets

13 Risky Assets

Mean-Variance Utility 236 Measuring Risk 241 Counterparty Risk
243 Equilibrium in a Market for Risky Assets 243 How Returns
Adjust 245 Example: Value at Risk Example: Ranking Mutual Funds
Summary 249 Review Questions 250

14 Consumer's Surplus

Demand for a Discrete Good 252 Constructing Utility from Demand Other Interpretations of Consumer's Surplus 254 253From Consumer's Surplus to Consumers' Surplus 255 Approximating a Continuous Demand 255 Quasilinear Utility 255 Interpreting the Change in Consumer's Surplus 256 Example: The Change in Consumer's Surplus Compensating and Equivalent Variation 258 Example: Compensating and Equivalent Variations Example: Compensating and Equivalent Variation for Quasilinear Preferences Producer's Surplus 262 Benefit-Cost Rationing • Calculating Gains and Losses 266 Analysis 264 Summary 267 Review Questions 267 Appendix 268 Example: A Few Demand Functions Example: CV, EV, and Consumer's Surplus

15 Market Demand

From Individual to Market Demand 270 The Inverse Demand Function 272 Example: Adding Up "Linear" Demand Curves Discrete Goods 273 The Extensive and the Intensive Margin 273 Elasticity 274 Example: The Elasticity of a Linear Demand Curve Elasticity and Demand 276 Elasticity and Revenue 277 Example: Strikes and Profits Constant Elasticity Demands 280 Elasticity and Marginal Revenue 281 Example: Setting a Price Marginal Revenue Curves 283 Income Elasticity 284 Summary 285 Review Questions 286 Appendix 287 Example: The Laffer Curve Example: Another Expression for Elasticity

16 Equilibrium

Supply 293 Market Equilibrium 293 Two Special Cases 294 Inverse Demand and Supply Curves 295 Example: Equilibrium with Linear Curves Comparative Statics 297 Example: Shifting Both Curves Taxes 298 Example: Taxation with Linear Demand and Supply Pass-The Deadweight Loss of a Tax 304ing Along a Tax 302 Example: The Market for Loans Example: Food Subsidies Example: Subsidies in Iraq Pareto Efficiency **310** Example: Waiting in Line Summary 313 Review Questions 313

XII CONTENTS

17 Measurement

Summarize data 316 Example: Simpson's paradox Test 320 Estimating demand using experimental data 320 Effect of treatment 321
Estimating demand using observational data 322 Functional form • Statistical model • Estimation • Identification 324 What can go wrong? 326 Policy evaluation 327 Example: Crime and police
Summary 328 Review Questions 329

18 Auctions

Classification of Auctions **331** Bidding Rules • Auction Design 332 Example: Goethe's auction Other Auction Forms 336 Example: Late Bidding on eBay Position Auctions 338 Two Bidders • More Than Two Bidders • Quality Scores • Should you advertise on your brand? Auction revenue and number of bidders 342 341 Problems with Auctions 343 Example: Taking Bids Off the Wall The Winner's Curse $\mathbf{344}$ Stable Marriage Problem 345 Mechanism Design 346 Summary 348 Review Questions 349

19 Technology

Inputs and Outputs **350** Describing Technological Constraints **351** Examples of Technology **352** Fixed Proportions • Perfect Substitutes • Cobb-Douglas • Properties of Technology **354** The Marginal Product **356** The Technical Rate of Substitution **356** Diminishing Marginal Product **357** Diminishing Technical Rate of Substitution **357** The Long Run and the Short Run **358** Returns to Scale **358** Example: Datacenters Example: Copy Exactly! Summary **361** Review Questions **362**

20 Profit Maximization

Profits 363 The Organization of Firms 365 Profits and Stock Market
Value 365 The Boundaries of the Firm 367 Fixed and Variable Factors 368 Short-Run Profit Maximization 368 Comparative Statics
370 Profit Maximization in the Long Run 371 Inverse Factor Demand
Curves 372 Profit Maximization and Returns to Scale 373 Revealed
Profitability 374 Example: How Do Farmers React to Price Supports?
Cost Minimization 378 Summary 378 Review Questions 379 Appendix 380

21 Cost Minimization

Cost Minimization **382** Example: Minimizing Costs for Specific Technologies Revealed Cost Minimization **386** Returns to Scale and the Cost Function **387** Long-Run and Short-Run Costs **389** Fixed and Quasi-Fixed Costs **391** Sunk Costs **391** Summary **392** Review Questions **392** Appendix **393**

22 Cost Curves

Average Costs 396 Marginal Costs 398 Marginal Costs and Variable
Costs 400 Example: Specific Cost Curves Example: Marginal Cost
Curves for Two Plants Cost Curves for Online Auctions 404 Long-Run
Costs 405 Discrete Levels of Plant Size 407 Long-Run Marginal Costs
408 Summary 409 Review Questions 410 Appendix 411

23 Firm Supply

Market Environments 413 Pure Competition 414 The Supply Decision of a Competitive Firm 416 An Exception 418 Another Exception 419 Example: Pricing Operating Systems The Inverse Supply Function 421 Profits and Producer's Surplus 421 Example: The Supply Curve for a Specific Cost Function The Long-Run Supply Curve of a Firm 425 Long-Run Constant Average Costs 427 Summary 428 Review Questions 429 Appendix 429

24 Industry Supply

Short-Run Industry Supply 431 Industry Equilibrium in the Short Run Industry Equilibrium in the Long Run 433 The Long-Run Supply 432 Curve **435** Example: Taxation in the Long Run and in the Short Run The Meaning of Zero Profits **439** Fixed Factors and Economic Rent 440 Example: Taxi Licenses in New York City Economic Rent 442 Rental Rates and Prices 444 Example: Liquor Licenses The Politics of Rent 445 Example: Farming the Government Energy Policy 447 Two-Tiered Oil Pricing • Price Controls • The Entitlement Program • Carbon Tax Versus Cap and Trade 451 Optimal Production of Emissions • A Carbon Tax • Cap and Trade • Summary 455 Review Questions 455

25 Monopoly

Maximizing Profits**458**Linear Demand Curve and Monopoly**459**Markup Pricing**461**Example: The Impact of Taxes on a MonopolistInefficiency of Monopoly**463**Deadweight Loss of MonopolyIst Inefficiency of Monopoly**463**Deadweight Loss of MonopolyExample: The Optimal Life of a PatentExample: Patent ThicketsExample: Managing the Supply of PotatoesNatural MonopolyA69WhatCauses Monopolies?**472**Example: Diamonds Are ForeverExample:Pooling in Auction MarketsExample: Price Fixing in Computer MemoryMarketsSummary**476**Review Questions**476**Appendix**477**

26 Monopoly Behavior

Price Discrimination 480 First-Degree Price Discrimination 480 Example: First-degree Price Discrimination in Practice Second-Degree Price Discrimination 483 Example: Price Discrimination in Airfares Example: Prescription Drug Prices Third-Degree Price Discrimination 487 Example: Linear Demand Curves Example: Calculating Optimal Price Example: Price Discrimination in Academic Journals Discrimination Bundling 492 Example: Software Suites Two-Part Tariffs 493 Monopolistic Competition 494 A Location Model of Product Differentiation Product Differentiation 500 498 More Vendors **501** Summary 502 Review Questions 502

27 Factor Markets

Monopoly in the Output Market 503 Monopsony 506 Example: The
Minimum Wage Upstream and Downstream Monopolies 510 Summary
512 Review Questions 513 Appendix 513

28 Oligopoly

Choosing a Strategy 516 Example: Pricing Matching Quantity Lead-The Follower's Problem • The Leader's Problem • Price ership 517 Comparing Price Leadership and Quantity Leadership Leadership **522** 525 Simultaneous Quantity Setting 525 An Example of Cournot Equilibrium **527** Adjustment to Equilibrium **528** Many Firms in Cournot Equilibrium 529 Simultaneous Price Setting 530 Collu-Punishment Strategies 533 Example: Price Matching and sion **531** Competition Example: Voluntary Export Restraints Comparison of the Solutions 537 Summary 537 Review Questions 538

29 Game Theory

The Payoff Matrix of a Game 540 Nash Equilibrium 542 Mixed Strategies 543 Example: Rock Paper Scissors The Prisoner's Dilemma 545 Repeated Games 547 Enforcing a Cartel 548 Example: Tit for Tat in Airline Pricing Sequential Games 550 A Game of Entry Deterrence 552 Summary 554 Review Questions 555

30 Game Applications

Best Response Curves **556** Mixed Strategies **558** Games of Coordination **560** Battle of the Sexes • Prisoner's Dilemma • Assurance Games • Chicken • How to Coordinate • Games of Competition **564** Games of Coexistence **569** Games of Commitment **571** The Frog and the Scorpion • The Kindly Kidnapper • When Strength Is Weakness • Savings and Social Security • Example: Dynamic inefficiency of price discrimination Hold Up • Bargaining **580** The Ultimatum Game • Summary **583** Review Questions **583**

XVI CONTENTS

31 Behavioral Economics

Framing Effects in Consumer Choice 586 The Disease Dilemma
Anchoring Effects • Bracketing • Too Much Choice • Constructed
Preferences • Uncertainty 590 Law of Small Numbers • Asset Integration and Loss Aversion • Time 593 Discounting • Self-control
Example: Overconfidence Strategic Interaction and Social Norms 595
Ultimatum Game • Fairness • Assessment of Behavioral Economics
597 Summary 599 Review Questions 599

32 Exchange

The Edgeworth Box 602 Trade 604 Pareto Efficient Allocations 605 Market Trade 607 The Algebra of Equilibrium 609 Walras' Law 611 Relative Prices 612 Example: An Algebraic Example of Equilibrium The Existence of Equilibrium 614 Equilibrium and Effi-The Algebra of Efficiency 616 ciency 615 Example: Monopoly in the Edgeworth Box Efficiency and Equilibrium 619 Implications of the First Welfare Theorem 621 Implications of the Second Welfare Theorem Review Questions 626 623 Summary 625 Appendix 626

33 Production

The Robinson Crusoe Economy **628** Crusoe, Inc. **630** The Firm 631 Robinson's Problem **632** Putting Them Together **632** Different Technologies 634 Production and the First Welfare Theorem 636 Production and the Second Welfare Theorem 637 Production Possibilities 637 Comparative Advantage 639 Pareto Efficiency 641 Castaways, Inc. 643 Robinson and Friday as Consumers 645 Decentralized Resource Allocation 646 Summary 647 Review Questions 647 Appendix 648

34 Welfare

Aggregation of Preferences651Social Welfare Functions653WelfareMaximization655Individualistic Social Welfare Functions657FairAllocations658Envy and Equity659Summary661Questions661Appendix662

35 Externalities

Smokers and Nonsmokers664Quasilinear Preferences and the CoaseTheorem667Production Externalities669Example: PollutionVouchersInterpretation of the Conditions674Market Signals677Example:Bees and AlmondsThe Tragedy of the Commons678Example:ample:OverfishingExample: New England LobstersAutomobile Pollutiontion682Summary684Review Questions684

36 Information Technology

Systems Competition 687 The Problem of Complements 687 Relationships among Complementors • Example: Apple's iPod and iTunes Example: Who Makes an iPod? Example: AdWords and AdSense Lock-A Model of Competition with Switching Costs • Example: In **693** Online Bill Payment Example: Number Portability on Cell Phones Network Externalities 697 Markets with Network Externalities 697 Mar-Example: Network Externalities in Computer Softket Dynamics 699 ware Implications of Network Externalities 703 Example: The Yellow Pages Example: Radio Ads Two-sided Markets 705 A Model of Two-sided Markets • Rights Management 706 Example: Video Rental Sharing Intellectual Property 708 Example: Online Two-sided Markets Summary 711 Review Questions 712

37 Public Goods

When to Provide a Public Good? 714 Private Provision of the Public
Good 718 Free Riding 718 Different Levels of the Public Good 720
Quasilinear Preferences and Public Goods 722 Example: Pollution
Revisited The Free Rider Problem 724 Comparison to Private Goods
726 Voting 727 Example: Agenda Manipulation The VickreyClarke-Groves Mechanism 730 Groves Mechanism • The VCG Mechanism
Examples of VCG 732 Vickrey Auction • Clarke-Groves
Mechanism • Problems with the VCG 733 Summary 734 Review
Questions 735 Appendix 735

38 Asymmetric Information

The Market for Lemons **738** Quality Choice **739** Choosing the Quality • Adverse Selection **741** Moral Hazard **743** Moral Hazard and Adverse Selection **744** Signaling **745** Example: The Sheepskin Effect Incentives **749** Example: Voting Rights in the Corporation Example: Chinese Economic Reforms Asymmetric Information **754** Example: Monitoring Costs Example: The Grameen Bank Summary **757** Review Questions **758**

Mathematical Appendix

Functions A1 Graphs A2 Properties of Functions A2 Inverse
Functions A3 Equations and Identities A3 Linear Functions A4
Changes and Rates of Change A4 Slopes and Intercepts A5 Absolute
Values and Logarithms A6 Derivatives A6 Second Derivatives A7
The Product Rule and the Chain Rule A8 Partial Derivatives A8
Optimization A9 Constrained Optimization A10

Answers

A11

Index

A31