
Springer Texts in Business and Economics

For further volumes:
<http://www.springer.com/series/10099>

Peter Dorman

Microeconomics

A Fresh Start

 Springer

Peter Dorman
The Evergreen State College
Olympia, WA, USA

ISSN 2192-4333 ISSN 2192-4341 (electronic)
ISBN 978-3-642-37433-3 ISBN 978-3-642-37434-0 (eBook)
DOI 10.1007/978-3-642-37434-0
Springer Heidelberg New York Dordrecht London

Library of Congress Control Number: 2014941109

© Springer-Verlag Berlin Heidelberg 2014

This work is subject to copyright. All rights are reserved by the Publisher, whether the whole or part of the material is concerned, specifically the rights of translation, reprinting, reuse of illustrations, recitation, broadcasting, reproduction on microfilms or in any other physical way, and transmission or information storage and retrieval, electronic adaptation, computer software, or by similar or dissimilar methodology now known or hereafter developed. Exempted from this legal reservation are brief excerpts in connection with reviews or scholarly analysis or material supplied specifically for the purpose of being entered and executed on a computer system, for exclusive use by the purchaser of the work. Duplication of this publication or parts thereof is permitted only under the provisions of the Copyright Law of the Publisher's location, in its current version, and permission for use must always be obtained from Springer. Permissions for use may be obtained through RightsLink at the Copyright Clearance Center. Violations are liable to prosecution under the respective Copyright Law.

The use of general descriptive names, registered names, trademarks, service marks, etc. in this publication does not imply, even in the absence of a specific statement, that such names are exempt from the relevant protective laws and regulations and therefore free for general use.

While the advice and information in this book are believed to be true and accurate at the date of publication, neither the authors nor the editors nor the publisher can accept any legal responsibility for any errors or omissions that may be made. The publisher makes no warranty, express or implied, with respect to the material contained herein.

Printed on acid-free paper

Springer is part of Springer Science+Business Media (www.springer.com)

Acknowledgements

Most introductory-level textbooks, at least in the U.S. market, are now the products of vast armies: not just the authors whose names you see on the cover, but hordes of reviewers, research assistants, design specialists, and others whose job is to help assemble, edit, shape and market the book itself and then all the ancillary items—the websites, test banks, instructors' slides, videos, and other enhancements that keep emerging from the development of new technology.

This book was written entirely by one person with just a tiny bit of assistance. There are costs to this approach, which I will get to shortly, but one big advantage: it is possible to offer a new, coherent vision of the subject matter, free from any pressure to conform to how things have been done in the past. In economics, I think this one plus outweighs all the minuses, but you can judge for yourself.

Of course, no book of this type is truly the product of just one individual. Just to be in a position to write it, I had to make my way to professional status as an economist, and that I owe above all to my dissertation chair, Herb Gintis. To say that Herb was an ideal advisor would be an understatement; he really took me under his wing and did whatever it took (including occasional childcare) to help me succeed. My debt to him cannot ever be repaid.

As a teaching professor of economics I have benefitted enormously from my colleagues at Evergreen State College, where I have worked for the past 15 years. Most teaching at Evergreen is interdisciplinary, undertaken in teams. I have taught economics in the context of biology, ecology, physics, history, sociology, philosophy, political science and cultural studies. This has been an invaluable laboratory for seeing the place of economics in the broad expanse of human knowledge and for augmenting my economist's skills with those honed by other kinds of training. Their impact on this textbook should be obvious.

In addition, Evergreen is one of the premier teaching institutions of higher education in North America. It has played a pioneering role in the development of learning communities, inquiry-centered courses, active learning strategies and other innovations. I have been honored to teach with colleagues who are master educators by any definition of the term, and most of what I have learned as a teacher I owe to them.

On the receiving end of my experimentation in the classroom have been my students. In more ways than I could document they have left their traces on this text, some by making specific recommendations, others simply by showing me what

works and what doesn't. Their patience and goodwill, and above all their thirst for learning, has made it possible for me to develop new approaches to teaching economics through trial and error. And the more I took the plunge into rethinking how introductory economics could be refashioned, the more necessary a new kind of textbook appeared. The very idea of this book emerged logically from my interactions with students at Evergreen.

Once I realized I needed to write a textbook, the biggest challenge was getting started. Here I can credit Peter Barnes, who provided a month's glorious solitude at Mesa Refuge. By the time I left, about a third of the micro text had been drafted and I had discovered a smart, friendly and socially committed colleague. Several pages of the text bear his imprint and are much the better for it. Since then I have also benefitted from reviews of individual chapters, especially by Matson Boyd, Josh Mason and Sevinç Rende.

To be published, a book still needs a publisher (although this may be changing). I was fortunate that Barbara Fess of Springer saw value in the unfinished work I sent her, and she has kept me on track through the final revisions. When I think I am missing all the inputs that a more commercially-oriented publisher might provide, I remind myself how professionally satisfied I am working with Springer and how supportive Barbara and her colleagues are of my vision. It's well worth it.

But that brings me to the downside of working on my own. Economics is a vast subject matter, and no one can possibly encompass all of it. Although I have gone over it again and again, I am sure this text has its share of errors and omissions. Here I depend on you. Please make note of any flaws you discover and take the time to let me know. I will post them on the web and incorporate fixes in any future edition. Many thanks in advance!

Finally, the sheer time and effort that goes into a project like this places a strain on any relationship. I am deeply grateful that Heike Nolte has coped with understanding and generosity. I thank her for being wonderful in general and for putting up with my questionable American work habits.

Contents

Part I Foundations

| | | |
|----------|--|----|
| 1 | Economics and the Economy | 3 |
| 1.1 | Myth #1: Economics Is the Study of How to Make Money | 3 |
| 1.2 | Myth #2: Economics Says that Supply and Demand in Free Markets Solves All Our Economic Problems | 4 |
| 1.3 | Myth #3: Economics Is About “Economizing”—Holding Down Costs | 5 |
| 1.4 | Myth #4: Economists Want to Increase the Amount of Money Possessed by Individuals or Communities | 5 |
| 1.5 | Is Economics the Study of the Economy? | 6 |
| 1.6 | What Economics Is | 7 |
| 2 | Economics Yesterday and Today | 9 |
| 2.1 | The Historical Context | 10 |
| 2.2 | Adam Smith | 12 |
| 2.3 | Economics in Other Languages | 16 |
| 2.4 | Economics Today: In the Image of Science | 17 |
| 3 | Four Building Blocks of Economic Theory | 27 |
| 3.1 | Choice and Exchange: Metaphors for Economic Life | 27 |
| 3.2 | Psychology: The Assumption of Rational Self-Interest | 32 |
| 3.3 | Rationality and Uncertainty | 34 |
| 3.4 | Individual and Collective Rationality | 38 |
| 3.5 | Equilibrium: People as Particles | 45 |
| 3.6 | Systems of Allocation | 48 |
| 4 | Values and Objectives | 55 |
| 4.1 | The Economy as a Machine | 55 |
| 4.2 | Economic Benefits | 57 |
| 4.3 | Economic Costs | 58 |
| 5 | Analyzing Markets | 69 |
| 5.1 | Introduction: Crisis in a Cup | 69 |
| 5.2 | Some Simplifying Assumptions | 71 |
| 5.3 | A First Look | 73 |

| | | |
|---------------------------------|--|------------|
| 5.4 | Using Supply and Demand | 84 |
| 5.5 | Another Cup of Coffee | 88 |
| 6 | Markets and Human Well-Being | 95 |
| 6.1 | Introduction | 95 |
| 6.2 | A Historical Detour | 96 |
| 6.3 | The Invisible Hand | 98 |
| 6.4 | The Market Welfare Model at the Level of a Single Market | 99 |
| 6.5 | Implications of the Market Welfare Model | 106 |
| 6.6 | Market Failure | 109 |
| | Appendix: Markets and Freedom | 114 |
| | Positive and Negative Liberty | 115 |
| | Inner Freedom | 119 |
| | Freedom and Obligation | 119 |
| Part II Institutions | | |
| 7 | Markets | 125 |
| 7.1 | Markets in History | 125 |
| 7.2 | The Enforcement Problem | 126 |
| 7.3 | The Complexity Problem | 131 |
| 7.4 | Markets and Information | 134 |
| 7.5 | Search Costs | 135 |
| 7.6 | Asymmetric Information | 137 |
| 7.7 | Market Efficiency | 141 |
| 8 | Firms | 149 |
| 8.1 | A Taxonomy of Business Organizations | 149 |
| 8.2 | Aspects of the Modern Corporation | 152 |
| 8.3 | The Need for a Theory | 158 |
| 8.4 | From Adam Smith to Alfred Marshall | 160 |
| 8.5 | Transaction Cost Theory | 162 |
| 8.6 | Entrepreneurial Theory | 164 |
| 8.7 | Current Debates | 167 |
| 9 | Government | 173 |
| 9.1 | State Capacity | 173 |
| 9.2 | Powers of Government | 176 |
| 9.3 | Democracy | 180 |
| 9.4 | Majority Rule | 181 |
| 9.5 | Government and Society | 184 |
| 10 | Civil Society | 193 |
| 10.1 | Why Civil Society Matters | 193 |
| 10.2 | Collective Action | 195 |
| 10.3 | Cooperation in the Repeated Prisoner's Dilemma | 197 |
| 10.4 | Cooperation in the Many-Player Prisoner's Dilemma | 200 |

10.5 Cooperation in More Realistic Models of Social Behavior 203
 10.6 Families as Economic Units 207
 10.7 Social Capital 210

Part III A Closer Look at Markets

11 The Theory of Demand 217
 11.1 Utility and Utilitarianism 218
 11.2 Utility and Individual Choice 220
 11.3 Market Demand, Consumer Surplus and Utility 223
 11.4 Do Consumers Maximize Utility? 229
 11.5 The Pursuit of Happiness 231
 11.6 Capabilities 234
 Appendix: Indifference Curves 238

12 Production Costs and the Theory of Supply 249
 12.1 The Meaning of Cost 249
 12.2 The Structure of Short Run Production Costs 252
 12.3 The Individual Firm’s Cost of Production in the Short Run 254
 12.4 Production Costs and the Supply Curve in the Short Run 259
 12.5 Production Costs and Market Supply in the Long Run:
 The Adjustment Process 263
 12.6 Production Costs and Market Supply in the Long Run:
 The Planning Process 267
 12.7 Mass Production, Computers and the LRAC Curves
 of the Future 271

13 Monopoly Power 275
 13.1 Perfect Competition: A World Without Power 275
 13.2 Barriers to Competition 278
 13.3 Pure Monopoly 280
 13.4 Between Pure Monopoly and Perfect Competition 287
 13.5 Is Concentration a Problem? 289
 13.6 Natural Monopoly 290
 13.7 Competition Policy 292

14 The Economics of Bargaining Power 297
 14.1 Where Does Bargaining Power Appear? 300
 14.2 An Elementary Model of Bargaining 301
 14.3 Extensions to the Basic Bargaining Model 307
 14.4 Bargaining Power in Action 310

15 Market Failure 315
 15.1 Public Goods 315
 15.2 Externalities 320
 15.3 Remedies for Externalities 325
 15.4 New Types of Externalities 330
 15.5 Taking Stock 331

Part IV Microeconomic Challenges

| | |
|--|-----|
| 16 Labor and Employment | 339 |
| 16.1 The Theory of Factor Markets | 340 |
| 16.2 Labor as a Factor of Production | 344 |
| 16.2.1 Supply and Demand at the Level of a Single Firm | 345 |
| 16.2.2 Supply and Demand for Labor Across an Entire Economy | 347 |
| 16.3 Labor Markets When Jobs and Workers Are Not the Same | 354 |
| 16.3.1 Differences in Jobs | 354 |
| 16.3.2 Differences in Workers | 357 |
| 16.3.3 Differences in Performance | 360 |
| 16.4 Bargaining Power at Work | 363 |
| 16.5 Unions and Worker Bargaining Power | 364 |
| 17 Financial Markets | 369 |
| 17.1 The Mystery of Capital | 369 |
| 17.2 Equity Markets | 373 |
| 17.3 Credit Markets | 378 |
| 17.4 Commodity Markets | 382 |
| 17.5 Default | 383 |
| 17.6 Two Models of Financing Business | 385 |
| 17.7 Are Financial Markets Efficient? | 389 |
| Reference | 395 |
| 18 Inequality | 397 |
| 18.1 Some Initial Evidence | 399 |
| 18.2 What About Mobility? | 402 |
| 18.3 Inequality by Gender and Race | 404 |
| 18.4 Measuring Inequality | 406 |
| 18.5 The Functional Distribution of Income | 409 |
| 18.6 Income Inequality: Explanations and Policy Responses | 410 |
| 18.7 Discrimination | 414 |
| Appendix: Theories of Distributive Justice | 422 |
| References | 429 |
| 19 Poverty | 431 |
| 19.1 What Is Poverty? | 433 |
| 19.2 Mass Poverty in the Global Economy | 437 |
| 19.3 Poverty Among Riches | 446 |
| 20 Economics and Ecology | 459 |
| 20.1 Ecology: A Big Omission | 460 |
| 20.2 The Environment as a Commons | 460 |
| 20.3 Natural Resources as Economic Inputs | 467 |
| 20.4 Pollution | 471 |
| 20.5 Sustainability | 474 |
| 20.6 Complexity and Uncertainty | 478 |

| | |
|---|-----|
| 21 Markets as Systems | 487 |
| 21.1 Economic Efficiency and the Pareto Principle | 488 |
| 21.2 General Equilibrium | 492 |
| 21.3 Applied General Equilibrium Models | 495 |
| 21.4 The General Theory of the Second Best | 497 |
| 21.5 Out-of-equilibrium Trading and the Indeterminacy of Equilibrium | 500 |
| 21.6 Interaction Effects and Multiple Equilibria | 502 |
| 21.7 A Final Summing Up | 512 |
| Glossary | 517 |
| Index | 529 |