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PRINCIPLES OF ECONOMICS

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Principles of economics
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PREFACE TO THIS EDITION

Studying economics should invigorate and enthrall. It should challenge students' preconceptions and provide them with a powerful, coherent framework for analysing the world they live in. Yet, all too often, economics textbooks are dry and confusing. Rather than highlighting the important foundations of economic analysis, these books focus on the 'ifs' and 'buts'. The motto underlying this book is that it is 'the rule, not the exception' that is important. Our aim is to show the power of economic tools and the importance of economic ideas.

This book has been designed particularly for students in Australia and New Zealand. However, we are keenly aware of the diverse mix of students studying in these countries. When choosing examples and applications, we have kept an international focus. Whether the issue is sauce tariffs in the EU, rent control in Mumbai, the Global Financial Crisis, road tolls in Singapore or the gas industry in Australia, examples have been chosen for their relevance and to highlight that the same economic questions are being asked in many countries. The specific context in which economics is applied may vary, but the lessons and insights offered by the economic way of thinking are universal.

To boil economics down to its essentials, we had to consider what is truly important for students to learn in their first course in economics. As a result, this book differs from others not only in its length but also in its orientation.

It is tempting for professional economists writing a textbook to take the economist's point of view and to emphasise those topics that fascinate them and other economists. We have done our best to avoid that temptation. We have tried to put ourselves in the position of students seeing economics for the first time. Our goal is to emphasise the material that students should and do find interesting about the study of the economy.

One result is that more of this book is devoted to applications and policy, and less is devoted to formal economic theory, than is the case with many other books written for the principles course. For example, after students learn about the market forces of supply and demand in chapters 4 to 6, they immediately apply these tools in chapters 7 to 9 to consider three important questions facing our society: Why is the free market a good way to organise economic activity? How does taxation interfere with the market mechanism? Who are the winners and losers from international trade? These kinds of questions resonate with the concerns and interests that students hear about in the news and bring from their own lives.

Throughout this book we have tried to return to applications and policy questions as often as possible. Most chapters include case studies illustrating how the principles of economics are applied. In addition, 'In the news' boxes offer excerpts from newspaper and magazine articles showing how economic ideas shed light on the current issues facing society. It is our hope that after students finish their first course in economics, they will think about news stories from a new perspective and with greater insight.

To write a brief and student-friendly book, we had to consider new ways to organise the material. This book includes all the topics that are central to a first course in economics, but the topics are not always arranged in the traditional order. What follows is a whirlwind tour of this text. This tour will, we hope, give instructors some sense of how the pieces fit together.

Chapter 1, 'Ten lessons from economics', introduces students to the economist's view of the world. It previews some of the big ideas that recur throughout economics, such as opportunity

cost, marginal decision making, the role of incentives, the gains from trade and the efficiency of market allocations. Throughout the book, we refer regularly to the Ten Lessons from Economics in chapter 1 to remind students that these lessons are the foundation for most economic analysis. A key icon in the margin calls attention to these references.

Chapter 2, 'Thinking like an economist', examines how economists approach their field of study. It discusses the role of assumptions in developing a theory and introduces the concept of an economic model. It also discusses the role of economists in making policy. The appendix to this chapter offers a brief refresher course on how graphs are used and how they can be abused.

Chapter 3, 'Interdependence and the gains from trade', presents the theory of comparative advantage. This theory explains why individuals trade with their neighbours, and why nations trade with other nations. Much of economics is about the coordination of economic activity through market forces. As a starting point for this analysis, students see in this chapter why economic interdependence can benefit everyone. This is done using a familiar example of trade in household chores among flatmates.

The next three chapters introduce the basic tools of supply and demand. Chapter 4, 'The market forces of supply and demand', develops the supply curve, the demand curve and the notion of market equilibrium. Chapter 5, 'Elasticity and its application', introduces the concept of elasticity and uses it in three applications to quite different markets. Chapter 6, 'Supply, demand and government policies', uses these tools to examine price controls, such as rent control, the award wage system, tax incidence and subsidies.

Attention then turns to welfare analysis using the tools of supply and demand. Chapter 7, 'Consumers, producers and the efficiency of markets', extends the analysis of supply and demand using the concepts of consumer surplus and producer surplus. It begins by developing the link between consumers' willingness to pay and the demand curve and the link between producers' costs of production and the supply curve. It then shows that the market equilibrium maximises the sum of the producer and consumer surplus. In this book, students learn about the efficiency of market allocations early in their studies.

The next two chapters apply the concepts of producer and consumer surplus to questions of policy. Chapter 8, 'Application: The costs of taxation', examines the deadweight loss of taxation. Chapter 9, 'Application: International trade', examines the winners and losers from international trade and the debate about protectionist trade policies.

Having examined why market allocations are often desirable, the book then considers how the government can sometimes improve on market allocations. Chapter 10, 'Externalities', examines why external effects such as pollution can render market outcomes inefficient. It also examines the possible public and private solutions to those inefficiencies. This has become highly relevant as policymakers attempt to deal with mitigating the causes of climate change. Chapter 11, 'Public goods and common resources', considers the inefficiencies that arise for goods that have no market price, such as national defence. Chapter 12, 'The design of the tax system', examines how the government raises the revenue necessary to pay for public goods. It presents some institutional background about the tax system and then discusses how the goals of efficiency and equity come into play in the design of a tax system.

The next six chapters examine firm behaviour and industrial organisation. Chapter 13, 'The costs of production', discusses what to include in a firm's costs and introduces cost curves.

Chapter 14, 'Firms in competitive markets', analyses the behaviour of price-taking firms and derives the market supply curve. Chapter 15, 'Monopoly', discusses the behaviour of a firm that is the sole seller in its market. It discusses the inefficiency of monopoly pricing and the value of price discrimination. Chapter 16, 'Monopolistic competition', examines behaviour in a market in which many sellers offer similar but differentiated products. It also discusses the debate about the effects of advertising. Chapter 17, 'Oligopoly and business strategy', examines markets when there are only a few sellers and so strategic interactions are important. It uses the prisoners' dilemma as the model for examining strategic interaction. Chapter 18, 'Competition policy' describes the policy instruments used by governments to control monopoly power and preserve competition in markets.

Microeconomic reform is discussed throughout the chapters on firm behaviour and industrial organisation rather than as a separate topic. For instance, the role of privatisation is included in chapter 15, and competition and trade practices issues are discussed in chapter 18. Also, note that chapter 17 includes an appendix that can be used to teach students about the differences between price and quantity competition in oligopoly. This appendix makes the latest game-theoretic thinking on these issues accessible to introductory economics students.

The next three chapters examine issues related to labour markets. Chapter 19, 'The markets for the factors of production', emphasises the link between factor prices and marginal productivity. It includes an appendix on the firm demand for labour under imperfect competition and monopoly. Chapter 20, 'Earnings, unions and discrimination', discusses the determinants of equilibrium wages, including compensating differentials, human capital, unions, efficiency wages and discrimination. The union discussion goes beyond simplistic analyses of unions and monopolists, introducing union behaviour as part of a bargaining equilibrium in bilateral monopoly. The discussion of human capital and efficiency wages proves a convenient point to introduce students to the concepts of signalling and asymmetric information. Chapter 21, 'Income inequity and poverty,' examines the degree of inequality in Australian society, the alternative views about the government's role in changing the distribution of income, and the various policies aimed at helping society's poorest members.

Chapter 22, 'The theory of consumer choice', analyses individual decision making using budget constraints and indifference curves. Finally, Chapter 23 goes beyond standard microeconomics to examine cutting-edge issues such as the role of information, political economy and behavioural economics; all of which help explain more of what happens in the real world. These last two chapters cover material that is somewhat more advanced than the rest of the book. Some instructors may want to skip the last chapter, depending on the emphases of their courses and the interests of their students. Instructors who do cover this material may want to move it earlier, and we have written this chapter so that it can be covered any time after the basics of supply and demand have been introduced.

Beginning in chapter 24, the book turns to the topics of macroeconomics. The coverage starts with the issues of measurement. Chapter 24, 'Measuring a nation's income', discusses the meaning of gross domestic product and related statistics from the national income accounts. Chapter 25, 'Measuring the cost of living', discusses the measurement and use of the consumer price index.

The next three chapters describe the behaviour of the real economy in the long run over which wages and prices are flexible. Chapter 26, 'Production and growth', examines the determinants of the large variation in living standards over time and across countries. Chapter 27, 'Saving, investment and the financial system', discusses the types of financial institutions in our economy and examines the role of these institutions in allocating resources. Chapter 28, 'The natural rate of unemployment',

considers the long-run determinants of the unemployment rate, including minimum-wage laws, the market power of unions, the role of efficiency wages and the efficacy of job search.

Having described the long-run behaviour of the real economy, the book then turns to the long-run behaviour of money and prices. Chapter 29 'The monetary system', introduces the economist's concept of money and the role of the central bank in influencing the amount of money in the economy. Chapter 30, 'Inflation: Its causes and costs', develops the link between money growth and inflation and discusses the social costs of inflation.

The next two chapters present the macroeconomics of open economies. Chapter 31, 'Open-economy macroeconomics: Basic concepts', explains the relationship among saving, investment and the trade balance, the distinction between the nominal and real exchange rate, and the theory of purchasing-power parity. Chapter 32, 'A macroeconomic theory of the open economy', presents a classical model of the international flow of goods and capital. The model sheds light on various issues, including the link between budget deficits and trade deficits and the macroeconomic effects of trade policies. Because instructors differ in how much they emphasise this material, these chapters were written so they could be used in different ways. Some instructors may choose to cover chapter 31 but not chapter 32; others may skip both chapters; and others may choose to defer the analysis of open-economy macroeconomics until the end of their courses.

After fully developing the long-run theory of the economy in chapters 26 to 34, the book turns its attention to explaining short-run fluctuations around the long-run trend. This organisation simplifies the teaching of the theory of short-run fluctuations because, at this point in the course, students have a good grounding in many basic macroeconomic concepts. Chapter 33, 'Aggregate demand and aggregate supply', begins with some facts about the business cycle and then introduces the model of aggregate demand and aggregate supply. Chapter 34, 'The influence of monetary and fiscal policy on aggregate demand', explains how policymakers can use the tools at their disposal to shift the aggregate-demand curve. Chapter 35, 'The short-run trade-off between inflation and unemployment', explains why policymakers who control aggregate demand face a trade-off between inflation and unemployment. It examines why this trade-off exists in the short run, why it shifts over time, and why it does not exist in the long run. A brand new chapter 36 is devoted to the Global Financial Crisis of 2008. It discusses the causes of the crisis and its effect on many economic variables, the responses of monetary and fiscal policy to the crisis, as well as the lessons we can learn from it in order to avoid future crises.

The book concludes with chapter 37, 'Five debates over macroeconomic policy'. This capstone chapter considers five controversial issues facing policymakers: the proper degree of policy activism in response to the business cycle, the choice between rules and discretion in the conduct of monetary policy, the desirability of reaching zero inflation, the importance of balancing the government's budget, and the need for tax reform to encourage saving. For each issue, the chapter presents both sides of the debate and encourages students to make their own judgements.

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PREFACE TO THE ORIGINAL EDITION

During my twenty-year career as a student, the course that excited me most was the two-semester sequence on the principles of economics I took during my freshman year in college. It is no exaggeration to say that it changed my life.

I had grown up in a family that often discussed politics over the dinner table. The pros and cons of various solutions to society's problems generated fervent debate. But, in school, I had been drawn to the sciences. Whereas politics seemed vague, rambling and subjective, science was analytic, systematic and objective. While political debate continued without end, science made progress.

My freshman course on the principles of economics opened my eyes to a new way of thinking. Economics combines the virtues of politics and science. It is, truly, a social science. Its subject matter is society – how people choose to lead their lives and how they interact with one another. But it approaches its subject with the dispassion of a science. By bringing the methods of science to the questions of politics, economics tries to make progress on the fundamental challenges that all societies face.

I was drawn to write this book in the hope that I could convey some of the excitement about economics that I felt as a student in my first economics course. Economics is a subject in which a little knowledge goes a long way. (The same cannot be said, for instance, of the study of physics or the Japanese language.) Economists have a unique way of viewing the world, much of which can be taught in one or two semesters. My goal in this book is to transmit this way of thinking to the widest possible audience and to convince readers that it illuminates much about the world around them.

I am a firm believer that everyone should study the fundamental ideas that economics has to offer. One of the purposes of general education is to make people more informed about the world in order to make them better citizens. The study of economics, as much as any discipline, serves this goal. Writing an economics textbook is, therefore, a great honour and a great responsibility. It is one way that economists can help promote better government and a more prosperous future. As the great economist Paul Samuelson put it, 'I don't care who writes a nation's laws, or crafts its advanced treaties, if I can write its economics textbooks.'

N. Gregory Mankiw
July 2000

TO THE STUDENTS

'Economics is a study of mankind in the ordinary business of life.' So wrote Alfred Marshall, the great nineteenth-century economist, in his textbook, *Principles of Economics*. Although we have learned much about the economy since Marshall's time, this definition of economics is as true today as it was in 1890, when the first edition of his text was published.

Why should you, as a student in the twenty-first century, embark on the study of economics? There are three main reasons.

The first reason to study economics is that it will help you understand the world in which you live. There are many questions about the economy that might spark your curiosity. Why are houses more expensive in Sydney than in Hobart? Why do airlines charge less for a return ticket if the traveller stays over a Saturday night? Why are some people paid so much to play tennis? Why are living standards so meagre in many African countries? Why do some countries have high rates of inflation while others have stable prices? Why are jobs easy to find in some years and hard to find in others? These are just a few of the questions that a course in economics will help you answer.

The second reason to study economics is that it will make you a more astute participant in the economy. As you go about your life, you make many economic decisions. While you are a student, you decide how many years you will continue with your studies. Once you take a job, you decide how much of your income to spend, how much to save and how to invest your savings. Someday you may find yourself running a small business or a large corporation, and you will decide what prices to charge for your products. The insights developed in the coming chapters will give you a new perspective on how best to make these decisions. Studying economics will not by itself make you rich, but it will give you some tools that may help in that endeavour.

The third reason to study economics is that it will give you a better understanding of the potential and limits of economic policy. As a voter, you help choose the policies that guide the allocation of society's resources. When deciding which policies to support, you may find yourself asking various questions about economics. What are the burdens associated with alternative forms of taxation? What are the effects of free trade with other countries? What is the best way to protect the environment? How does a government budget deficit affect the economy? These and similar questions are always on the minds of policymakers whether they work for a local council or the prime minister's office.

Thus, the principles of economics can be applied in many of life's situations. Whether the future finds you reading the newspaper, running a business or running a country, you will be glad that you studied economics.

Joshua S. Gans

Stephen P. King

Robin E. Stonecash

Martin C. Byford

Jan Libich

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March 2014

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Professor Gans lives in Toronto with his partner, Natalie Lippey, and children, Belanna, Ariel and Annika.

Stephen King is Professor of Economics at Monash University and a Member of the Economic Regulation Authority of Western Australia. Prior to joining Monash, Stephen was a Commissioner at the Australian Competition and Consumer Commission. After starting (and stopping) studying Forestry and Botany, Stephen completed an economics degree at the Australian National University. He completed his PhD at Harvard University in 1991. Stephen has taught a variety of courses, including introductory courses at Harvard University and the University of Melbourne.

Professor King specialises in industrial economics, although his research has covered a wide range of areas, including game theory, corporate finance, privatisation and tax policy. His work has been published in academic journals such as the *Journal of Industrial Economics*, *European Economic Review* and *Journal of Political Economy*. Stephen regularly provides advice to both government and private firms on a range of issues relating to regulation and competition policy. He is a Lay Member of the High Court of New Zealand and a Fellow of the Academy of Social Sciences in Australia.

Professor King lives in Melbourne with his wife, Mary. Their two children, Jacqui and Rebecca, have run away from home to study at University.

Robin Stonecash is Director of Executive Education in the Department of Management Education at the University of Sydney's Business School. She was previously Director of Executive Education at the Business School at the University of Technology, Sydney, and Director of Stonecash Associates, a boutique consulting firm. She studied economics at

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Professor Stonecash's research interests cover a wide range of topics, including competition policy, privatisation, and international trade and development. Her work has been published in several journals, including *Economic Record*, *Prometheus* and *Public Performance and Management Review*. Professor Stonecash has also done several studies on the efficiency gains from outsourcing. She has consulted widely for private companies and government organisations such as AusAID and the Departments of Ageing and Disability and Community Services.

Professor Stonecash lives in Sydney with her husband, Mark.

Martin Byford is Lecturer of Economics at RMIT University. Prior to joining RMIT he was Assistant Professor of Economics at the University of Colorado at Boulder. Martin discovered economics during the final year of a combined Arts and Civil Engineering degree. Realising that he had made a terrible error in his choice of vocation, Martin went back to university to study economics. He completed a PhD at the University of Melbourne in 2007. Martin's introductory microeconomics course is currently taught on RMIT campuses in Australia, Singapore and Vietnam.

Dr Byford's research is primarily in the fields of industrial organisation and microeconomic theory. He has published in academic journals including the *Journal of Economics and Management Strategy*, and *Economic Papers*. Martin also contributes to economic policy debates on a diverse range of topics including the design of the banking system and labour market reform.

Dr Byford lives in Melbourne with his wife, Siobhan, and their son, Robert.

Jan Libich has been affiliated with the School of Economics at La Trobe University since 2005, and more recently also with VŠB-Technical University Ostrava, Czech Republic, and CAMA at the Australian National University. He completed his PhD at the University of New South Wales and his earlier studies at the Prague School of Economics.

Jan's research focuses on monetary and fiscal policy as well as on game theory and sports economics. Over the past decade Jan has been invited to present his research at over 70 seminars and conferences, including those at the International Monetary Fund, the London School of Economics, and a number of central banks such as the European Central Bank and the Federal Reserve. He has published over 20 papers in academic journals including *Macroeconomic Dynamics*, *Journal of Sports Economics*, *Economic Modelling*, *Journal of Macroeconomics* and *Economics Letters*.

In his attempt to help bridge the gap between academic research, economic policy, and the general public, Jan started recording one-hour video interviews with esteemed central bankers, politicians and academics (www.youtube.com/user/JanLibich1). For his teaching efforts he has received a number awards including, for example, a 2012 Citation from the Australian government. Jan was also voted by students the UniJobs Lecturer of the Year at La Trobe University four years in a row (2009–12).

Jan lives in Melbourne with his lovely wife Simona and their two cheerful boys, Adam and Dan.

N. Gregory Mankiw is Professor of Economics at Harvard University. As a student, he studied economics at Princeton University and MIT. As a teacher, he has taught macroeconomics, microeconomics, statistics and principles of economics. He even spent one summer long ago as a sailing instructor on Long Beach Island.

Professor Mankiw is a prolific writer and a regular participant in academic and policy debates. His work has been published in scholarly journals, such as the *American Economic Review*, *Journal of Political Economy* and *Quarterly Journal of Economics*, and in more popular forums, such as *The New York Times*, *Boston Globe* and *The Wall Street Journal*. He is also the author of the best-selling intermediate-level textbook *Macroeconomics* (Worth Publishers). In addition to his teaching, research and writing, Professor Mankiw is a research associate of the National Bureau of Economic Research, an adviser to the Federal Reserve Bank of Boston and the Congressional Budget Office, and a member of the ETS test development committee for the advanced placement exam in economics.

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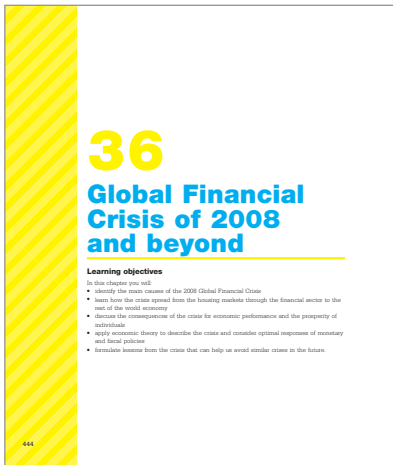
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RESOURCES GUIDE

FOR THE STUDENT

As you read this text you will find a wealth of features in every chapter to enhance your study of economics and help you understand how it is applied in the real world.



Where you see this symbol, you should refer to the **Ten lessons from economics** found in chapter 1 of this text.

Learning objectives are listed at the start of each chapter giving you a clear sense of what the chapter will cover.

The **Introduction** is a short story, focused on the chapter topic, about how economics affects you on a daily basis without you even noticing.



When **key terms** are used in the text for the first time, they are bolded, coloured and defined in the margins. This will help you identify key concepts throughout the text.

IN THE NEWS

MOTHER NATURE SHIFTS THE SUPPLY CURVE

In this chapter we have seen three examples of how to use supply and demand curves to analyse a change in equilibrium. Whenever an event shifts the supply curve, the demand curve, or perhaps both curves, you can use these tools to predict how the event will alter the price and quantity sold in equilibrium. This article provides another example of how a natural disaster that reduces supply reduces the quantity sold and raises the price.

Bananas to recover quickly
by Tony Koch

Banana prices, which have risen because of crop devastation caused by Cyclone Yasi, will not stay high for long because of lessons learned by progressive farmers when Cyclone Larry caused similar havoc in 2006.

The advance notice of Yasi to growers in the Tully and Innisfail areas allowed a frenzied few days of picking mature fruit and storing it in packing sheds, ensuring at least two weeks' supply.

As well, farmers deleafed young trees, leaving just the stems standing, and these were not knocked over by the cyclonic winds as were the mature trees.

Australian banana production is 286 000 tonnes a year, or about 25 million cartons, each with 13 kg of fruit.

Gross value of the produce is \$500 million based on an average wholesale price of \$20 a carton.

The industry is estimated to be worth more than \$870m to the broader economy through the employment it provides and ancillary services. North Queensland has 12 000ha of plantations, producing about 85 per cent of Australia's crop.

More than 3000 people are employed directly in the banana industry in the cyclone-affected areas.

The Australian Banana Growers Council reported last week that 96 per cent of the crop in Tully and Innisfail was lost, or about 10 200ha, as well as 10 per cent on the Atherton Tableland (1350ha) and 100 per cent at Cardwell (630ha). Council chief executive Jonathan Eccles said about 5 per cent of crops in the Innisfail-Tully area had been defeated, which will mean those crops can be harvested four months or so earlier than crops that must be planted now.

'Banana supply from Innisfail and Tully will not be back to normal for at least six months, with full supply not expected before December 2011,' he said.

'As well as the deleafing helping some get back into production quicker, Cyclone Yasi affected crops differently from the way Larry did.

This time the stems were broken off higher up, about a metre and a half, and that stem is being left to provide nourishment for the adjoining sucker.

'The third thing working for farmers is that Yasi has come at the end of January and Larry hit towards the end of March, so there is a

Current economic news and events are presented as **In the news**. This selection of media and journal clippings will explore how economic ideas shed light on current affairs.

FYI

Elasticity and total revenue along a linear demand curve

Although some demand curves have an elasticity that is the same along the entire curve, that is not always the case. An example of a demand curve along which elasticity changes is a straight line, as shown in Figure 5.5. A linear demand curve has a constant slope. Recall that slope is defined as 'rise over run', which here is the ratio of the change in price ('rise') to the change in quantity ('run'). In this case, the demand curve's slope is constant because each \$1 increase in price causes the same 2-unit decrease in the quantity demanded.

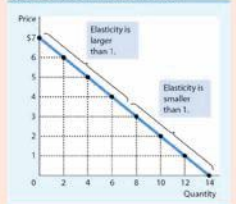
Even though the slope of a linear demand curve is constant, the elasticity is not. The reason is that the slope is the ratio of changes in the two variables, whereas the elasticity is the ratio of percentage changes in the two variables. You can see this most easily by

looking at Table 5.1. This table shows the demand schedule for the linear demand curve in Figure 5.5 and calculates the price elasticity of demand using the midpoint method discussed earlier. At points with low price and high quantity, the demand curve is inelastic. At points with a high price and low quantity, the demand curve is elastic. The explanation for this fact comes from the arithmetic of percentage changes. When the price is low and consumers are buying a lot, a \$1 price increase and 2-unit reduction in quantity demanded constitutes a large percentage increase in the price and a small percentage decrease in quantity demanded, resulting in a small elasticity. By contrast, when the price is high and consumers are not buying much, the same \$1 price increase and 2-unit reduction in quantity demanded constitutes a small percentage increase in the price and a large percentage decrease in quantity demanded, resulting in a large elasticity.

Table 5.1 also presents total revenue at each point on the demand curve. These numbers illustrate the relationship between total revenue and elasticity. When the price is \$1, for instance, demand is inelastic and a price increase to \$2 raises total revenue. When the price is \$5, demand is elastic and a price increase to \$6 reduces total revenue. Between \$3 and \$4, demand is exactly unit elastic and total revenue is the same at these two prices.

The linear demand curve illustrates that the price elasticity of demand need not be the same at all points on a demand curve. A constant elasticity is one possibility, but it is not always the case.

Figure 5.5 A linear demand curve



The slope of a linear demand curve is constant, but its elasticity is not.

QUIZ

List the determinants of the demand for pizza. Give an example of a demand schedule for pizza, and graph the implied demand curve. Give an example of something that would shift this demand curve. Would a change in the price of pizza shift this demand curve?

Throughout the chapter there are quick **quizzes** to assess your knowledge and comprehension of key topics.

What Australian economists think

There are a number of government policies that are generally opposed by economists. For example 66.2 per cent of economists would like to see an end to the stamp duty on home sales (stamp duties are state taxes payable when you buy or sell an asset), while 19.2 per cent of respondents disagree.

As experts, the role of economists in public policy formation is to analyse proposals and inform public debate. Of the economists:

surveyed 84.9 per cent agree with the statement: 'Prior to approval of any major public infrastructure project, an independent and expert cost-benefit study should be conducted and released publicly'. Only 8.5 per cent of respondents disagree.

Source: ESA Policy Opinion Survey of Australian Economists 2011. <http://esocentral.org.au/publications/useful-links/2011-policy-opinion-survey>

What Australian economists think

highlights recent policy issues using data from Economics Society of Australia.

CASE STUDY

Two ways to reduce the quantity of smoking demanded

Public policymakers often want to reduce the amount that people smoke because of smoking's adverse health effects. There are two ways that policy can attempt to achieve this goal.

One way to reduce smoking is to shift the demand curve for cigarettes and other tobacco products. Public service announcements, mandatory health warnings on cigarette packets and the prohibition of cigarette advertising are all policies aimed at reducing the quantity of cigarettes demanded at any given price. If successful, these policies shift the demand curve for cigarettes to the left, as in panel (a) of figure 4.4.

Alternatively, policymakers can try to raise the price of cigarettes. If the government taxes the manufacture of cigarettes, for example,

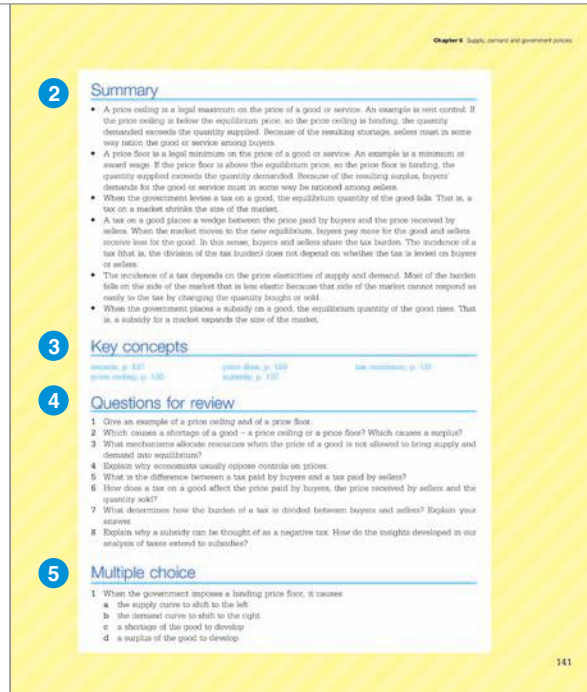
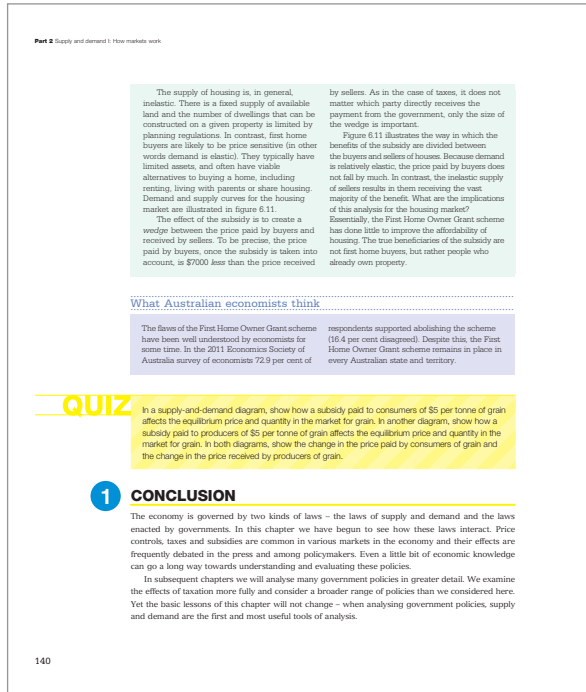
cigarette companies pass much of this tax on to consumers in the form of higher prices. A higher price encourages smokers to reduce the amount of cigarettes they smoke. In this case, the reduced amount of smoking does not represent a shift in the demand curve. Instead, it represents a movement along the same demand curve to a point with a higher price and lower quantity, as in panel (b) of figure 4.4.

How much does the amount of smoking respond to changes in the price of cigarettes? Economists have attempted to answer this question by studying what happens when the tax on cigarettes changes. They have found that a 10 per cent increase in the price causes a 4 per cent reduction in the quantity demanded. Teenagers are found to be especially sensitive

Case studies throughout the book will help you conceptualise key issues in the text, demonstrating how your knowledge can be applied to real-world situations.

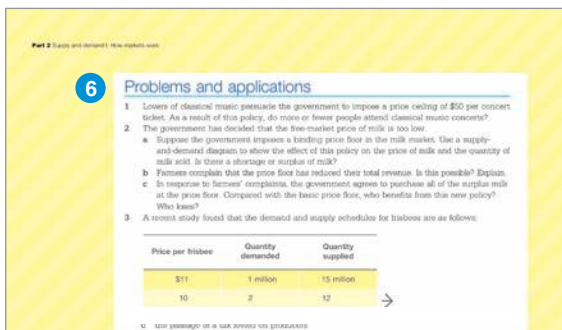
Useful economic facts can be found in the **FYI** boxes. They will provide you with additional information and material to support key concepts within each chapter.

At the end of each chapter there are several learning tools that will help you review the chapter and key concepts.



- The **Conclusion** puts the content into perspective.
- The end of chapter **Summary** provides you with key bullet points from the chapter.
- All **Key concepts** referred to in the chapter are listed and page-referenced to guide your revision.

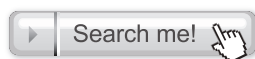
- Questions for review** ensure you have a complete understanding of the chapter's key concepts.
- Multiple choice questions** consolidate key ideas from the chapter.



- Problems and applications** enable you to apply the theory you have learned and encourage group discussion.

Online resources

Visit <http://login.cengage.brain.com> and login using the code card at the front of this book for access to the *Principles of Economics CourseMate Website*. You will find an ebook, quizzing, flashcards, crosswords, graphing workshops, videos and more tools to help you excel in your studies.



From <http://login.cengage.brain.com> you can also access *Search me! economics*. Fast and convenient, this resource provides you with 24-hour access to full-text articles from hundreds of scholarly and popular journals, ebooks and newspapers, including *The Australian* and *The New York Times*. Use the *Search me! economics* key words provided in the margins of each chapter to explore topics further and find current references. These terms will get you started – then try your own search terms to expand your knowledge.

FOR THE INSTRUCTOR

Cengage Learning is pleased to provide you with an extensive selection of resources that have been developed to supplement the sixth edition of *Principles of Economics*. These resources are available on the instructor's companion website accessible via <http://login.cengage.com>

Instructor's manual

The *Instructor's manual* provides you with a wealth of content to help set up and administer an introductory economics course. It includes learning objectives, chapter outlines, key points, figures from the texts, adjunct teaching and warm-up activities as well as solutions to problems in the text.

PowerPoint presentations

Chapter-by-chapter *PowerPoint presentations* cover the main concepts addressed within the text and can be edited to suit your own requirements. Use these slides to enhance your lecture presentations and to reinforce the key principles of your subject, or for students handouts.

ExamView test bank

ExamView helps you to create, customise and deliver tests in minutes for both print and online applications. The Quick Test Wizard and Online Test Wizard guide you step-by-step through the test creation process. With *ExamView's* complete word processing abilities, you can add an unlimited number of new questions to the bank, edit existing questions and build tests of up to 250 questions using 12 different question types. You can also export the files into Blackboard or WebCT.

Artwork

These digital files of graphs and figures from the book can be used in a variety of media. Add them into your course management system, use them with student handouts or copy them into lecture presentations.

part 1

Introduction

Chapter 1 Ten lessons from economics

Chapter 2 Thinking like an economist

Chapter 3 Interdependence and the gains from trade

1

Ten lessons from economics

Learning objectives

In this chapter you will:

- learn that economics is about the allocation of scarce resources
- examine some of the trade-offs that people face
- learn the meaning of opportunity cost
- see how to use marginal reasoning when making decisions
- discuss how incentives affect people's behaviour
- consider why trade among people or nations can be good for everyone
- discuss why markets are a good, but not perfect, way to allocate resources
- learn what determines some trends in the overall economy.

The word *economy* comes from the Greek word for ‘one who manages a household’. At first, this origin might seem peculiar. But, in fact, households and economies have much in common.

A household faces many decisions. It must decide which members of the household do which tasks and what each member receives in return. Who cooks dinner? Who does the laundry? Who gets the extra dessert at dinner? Who gets to use the car? In short, the household must allocate its scarce resources (time, dessert, petrol) among its various members, taking into account each member’s abilities, efforts and desires.

Like a household, a society faces many decisions. A society must decide what jobs will be done and who will do them. It needs some people to grow food, other people to make clothing and still others to design computer software. Once society has allocated people (as well as land, buildings and machines) to various jobs, it must also allocate the output of the goods and services that they produce. It must decide who will eat caviar and who will eat potatoes. It must decide who will drive a Porsche and who will take the bus.

The management of society’s resources is important because resources are scarce. **Scarcity** means that society has limited resources and therefore cannot produce all the goods and services people wish to have. Just as each member of a household cannot get everything he or she wants, each individual in society cannot attain the highest standard of living to which he or she might aspire.

Economics is the study of how society manages its scarce resources. In most societies, resources are allocated not by an all-powerful dictator but through the combined choices of millions of households and firms. Economists, therefore, study how people make decisions—how much they work, what they buy, how much they save and how they invest their savings. Economists also study how people interact with one another. For instance, they examine how the buyers and sellers of a good interact to determine the price at which the good is sold and the quantity that is sold. Finally, economists analyse forces and trends that affect the economy as a whole, including the growth in average income, the fraction of the population that cannot find work and the rate at which prices are rising.

The study of economics has many facets, but it is unified by several central ideas. In the rest of this chapter, we look at *Ten Lessons from Economics*. Don’t worry if you don’t understand them all at first or if you are not completely convinced. We explore these ideas more fully in later chapters. The 10 lessons are introduced here to give you an overview of what economics is all about.

scarcity
the limited nature of
society’s resources

economics
the study of how society
manages its scarce
resources

HOW PEOPLE MAKE DECISIONS

There is no mystery about what an ‘economy’ is. Whether we are talking about the economy of Sydney, of Australia or of the whole world, an economy is just a group of people interacting with one another as they go about their lives. Because the behaviour of an economy reflects the behaviour of the individuals who make up the economy, we begin our study of economics with four lessons about individual decision making.

Lesson 1: People face trade-offs

You may have heard the saying: ‘There is no such thing as a free lunch’. To get something that we like, we usually have to give up something else that we also like. Making decisions requires trading off one goal against another.

Consider a student who must decide how to allocate her most valuable resource – her time. She can spend all her time studying economics; she can spend all of her time studying psychology; or she can divide her time between the two fields. For every hour she studies one subject, she gives up an hour she could have used studying the other. And for every hour she spends studying, she gives up an hour that she could have spent sleeping, bike riding, watching TV or working at her part-time job for some extra spending money.

Or consider parents deciding how to spend their family income. They can buy food or clothing, or have a holiday. Or they can save some of the family income for retirement or the children's education. When they choose to spend an extra dollar on one of these goods, they have one less dollar to spend on some other good.

When people are grouped into societies, they face different kinds of trade-offs. The classic trade-off is between 'guns and butter'. The more we spend on defence to protect our shores from foreign aggressors (guns), the less we can spend on personal goods to raise our standard of living at home (butter). Also important in modern society is the trade-off between a clean environment and a high level of income. Laws that require firms to reduce pollution usually raise the cost of producing goods and services. Because of these higher costs, these firms end up earning smaller profits, paying lower wages, charging higher prices or some combination of these three. Thus, while pollution regulations give us the benefit of a cleaner environment and the improved health that comes with it, they have the cost of reducing the incomes of the regulated firms' owners, workers and customers.

Another trade-off society faces is between efficiency and equity. **Efficiency** means that society is getting the most it can from its scarce resources. **Equity** means that the benefits of those resources are distributed fairly among society's members. In other words, efficiency refers to the size of the economic pie, and equity refers to how the pie is divided. Often, when government policies are being designed, these two goals conflict.

Consider, for instance, policies aimed at achieving a more equitable distribution of economic wellbeing. Some of these policies, such as the age pension or unemployment benefits, try to help those members of society who are most in need. Others, such as the individual income tax, ask the financially successful to contribute more than others to support the government. Although these policies have the benefit of achieving greater equity, they have a cost in terms of reduced efficiency. When the government redistributes income from the rich to the poor, it can reduce the reward for working hard; as a result, people may work less and produce fewer goods and services. In other words, as the government tries to cut the economic pie into more equitable slices, the pie may get smaller.

Recognising that people face trade-offs does not by itself tell us what decisions they will or should make. A student should not abandon the study of psychology just because doing so would increase the time available for the study of economics. Society should not stop protecting the environment just because environmental regulations reduce our material standard of living. The poor should not be ignored just because helping them distorts work incentives. Nonetheless, acknowledging life's trade-offs is important because people are likely to make good decisions only if they understand the options that they have available. Our study of economics starts by acknowledging life's trade-offs.

Lesson 2: The cost of something is what you give up to get it

Because people face trade-offs, making decisions requires comparing the costs and benefits of alternative courses of action. In many cases, however, the cost of some action is not as obvious as it might first appear.

efficiency
the property of society getting the most it can from its scarce resources

equity
the property of distributing economic prosperity fairly among the members of society

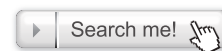
Consider, for example, the decision whether to go to university. The benefits include intellectual enrichment and a lifetime of better job opportunities. But what is the cost? To answer this question, you might be tempted to add up the money you or your parents spend on fees, books, rent and food. Yet this total does not truly represent what you give up to spend a year at university.

There are two problems with this calculation. First, it includes some things that are not really costs of university education. Even if you quit university, you would need a place to sleep and food to eat. Rent and food are costs of going to university only to the extent that they are more expensive because you are going to university. For instance, you might have to move cities to attend university and live away from home. Indeed, the cost of your room and food at your residential college or home might be less than the rent and food expenses that you would pay living on your own. In this case, the savings on the room and food are a benefit of going to university.

Second, this calculation ignores the largest cost of going to university—your time. When you spend a year listening to lectures, reading textbooks and writing assignments, you cannot spend that time working at a job. For most students, the wages given up to attend university are the largest single cost of their education.

The **opportunity cost** of an item is the best alternative you give up to get that item. When making any decision, such as whether to attend university, decision makers should be aware of the opportunity costs that accompany each possible action. In fact, they usually are. For example, some young athletes can earn millions if they forgo university and play professional sports. Their opportunity cost of university is very high. It is not surprising that they often decide that the benefit of a university education is not worth the opportunity cost.

opportunity cost
the best alternative that
must be given up to
obtain some item



opportunity cost

Lesson 3: Rational people think at the margin

Economists normally assume that people are rational. Rational people systematically and purposefully do the best they can do to achieve their objectives, given the opportunities they have. As you study economics, you will encounter firms that decide how many workers to hire and how much of their product to manufacture and sell to maximise profits. You will encounter individuals who decide how much time to spend working, and what goods and services to buy with the resulting income to achieve the highest possible level of satisfaction.

Rational people know that decisions in life are rarely black and white but usually involve shades of grey. At dinnertime, the choice you face is not ‘Should I fast or eat like a pig?’. More likely you will be asking yourself ‘Should I eat that extra spoonful of mashed potatoes?’. When exams roll around, your decision is not between blowing them off and studying 24 hours a day but whether to spend an extra hour reviewing your notes instead of watching TV. Economists use the term **marginal change** to describe a small incremental adjustment to an existing plan of action. Keep in mind that *margin* means ‘edge’, so marginal changes are adjustments around the edges of what you are doing. Rational people often make decisions by comparing *marginal benefits* and *marginal cost*.

For example, suppose you are considering calling a friend on your mobile phone. You decide that talking with her for 10 minutes would give you a benefit that you value at about \$7. Your mobile phone plan costs you \$40 per month plus \$0.50 per minute for whatever calls you make. You usually talk for 100 minutes a month, so your total monthly bill is \$90 (\$0.50 per minute times 100 minutes, plus the \$40 fixed fee). Under these circumstances, should you make the call? You might be tempted to reason as follows: ‘Because I pay \$90 for 100 minutes of calling each month,

marginal change
a small incremental
adjustment to a plan of
action

the average minute on the phone costs me \$0.90. So a 10-minute call costs \$9. Because that \$9 cost is greater than the \$7 benefit, I am going to skip the call.’ That conclusion is wrong, however. Although the average cost of a 10-minute call is \$9, the marginal cost—the amount your bill increases if you make the extra call—is only \$5. You will make the right decision only by comparing the marginal benefit and the marginal cost. Because the marginal benefit of \$7 is greater than the marginal cost of \$5, you should make the call. This is a principle that people innately understand: Mobile phone users with unlimited calls (that is, phone calls that are free at the margin) are often prone to make long and frivolous calls.



Source: Shutterstock.com/wavebreakmedia

Thinking at the margin works for business decisions as well. Consider an airline deciding how much to charge passengers who fly standby. Suppose that flying a 200-seat plane from Brisbane to Perth costs the airline \$100 000. In this case, the average cost of each seat is $\$100\,000/200$, which is \$500. One might be tempted to conclude that the airline should never sell a ticket for less than \$500. But the airline can often increase its profits by thinking at the margin. Imagine that a plane is about to take off with 10 empty seats and a standby passenger waiting at the gate will pay \$300 for a seat. Should the airline sell the ticket? Of course it should. If the plane has empty seats, the cost of adding one more passenger is tiny. Although the *average* cost of flying a passenger is \$500, the *marginal* cost is merely the cost of the sandwich and coffee that the extra passenger will consume. As long as the standby passenger pays more than the marginal cost, selling the ticket is profitable.

Marginal decision making can help explain some otherwise puzzling economic phenomena. Here is a classic question: Why is water so cheap, while diamonds are so expensive? Humans need water to survive, while diamonds are unnecessary; but for some reason, people are willing to pay much more for a diamond than for a cup of water. The reason is that a person’s willingness to pay for a good is based on the marginal benefit that an extra unit of the good would yield. The marginal benefit, in turn, depends on how many units a person already has. Although water is essential, the

marginal benefit of an extra cup is small because water is plentiful. By contrast, no one needs diamonds to survive, but because diamonds are so rare, people consider the marginal benefit of an extra diamond to be large.

A rational decision maker takes an action if and only if the marginal benefit of the action exceeds the marginal cost. This principle explains why people use mobile phones as much as they do, why airlines are willing to sell tickets below average cost and why people are willing to pay more for diamonds than for water. It can take some time to get used to the logic of marginal thinking, but the study of economics will give you ample opportunity to practise.

Lesson 4: People respond to incentives

An incentive is something (such as a punishment or reward) that induces a person to act. Because rational people make decisions by comparing costs and benefits, they respond to incentives. You will see that incentives play a central role in the study of economics. One economist went so far as to suggest that the entire field could be summarised simply: ‘People respond to incentives. The rest is commentary’.

Incentives are crucial to analysing how markets work. For example, when the price of an apple rises, people decide to eat fewer apples. At the same time, apple orchards decide to hire more workers and harvest more apples. In other words, a higher price in a market provides an incentive for buyers to consume less and an incentive for sellers to produce more. As we will see, the influence of prices on the behaviour of consumers and producers is crucial for understanding how the economy allocates scarce resources.

Public policymakers should never forget about incentives. Many policies change the costs or benefits that people face and, as a result, alter their behaviour. A tax on petrol, for instance, encourages people to drive smaller, more fuel-efficient cars. That is one reason people drive smaller cars in Europe and Australia, where petrol taxes are higher, than in the United States, where petrol taxes are low. A petrol tax also encourages people to take public transportation rather than drive, and to live closer to where they work. If the tax were larger, more people would be driving hybrid cars, and if it were large enough, they would switch to electric cars.

When policymakers fail to consider how behaviour might change as a result, their policies can have effects that they did not intend. For example, consider public policy toward seat belts and car safety. In the 1950s, few cars had seat belts. Today all cars do, and in Australia it is compulsory to wear seat belts. The reason for the change is public policy. In the late 1960s, the rising death toll from motor vehicle accidents in Australia generated much public concern over car safety. State governments responded and in December 1970 the Victorian government passed legislation requiring car drivers and passengers to wear seat belts. Other states followed and by 1973 it was compulsory throughout Australia to wear seat belts.

How does a seat belt law affect car safety? The direct effect is obvious. When wearing seat belts is compulsory, more people wear seat belts and the probability of surviving a major car accident rises. In this sense, seat belts save lives. This direct impact of seat belts on safety is what motivated Australian governments to change the law.

But that is not the end of the story because the law also affects behaviour by changing incentives. In this case, the relevant behaviour is the speed and care with which drivers operate their cars. Driving slowly and carefully is costly because it uses the driver’s time and energy. When deciding how safely to drive, rational people compare the marginal benefit from safer

driving with the marginal cost. They drive more slowly and carefully when the benefit of increased safety is high. This explains why people drive more slowly and carefully when roads are wet and slippery than when roads are clear.

Now consider how a seat belt law alters a driver's cost-benefit calculation. Seat belts make accidents less costly because they reduce the probability of injury or death. In other words, wearing a seat belt reduces the benefits of slow and careful driving. People respond to wearing seat belts as they would to an improvement in road conditions – by driving faster and less carefully. The result of a seat belt law, therefore, is a larger number of accidents. The decline in safe driving has a clear, adverse impact on pedestrians who are more likely to find themselves in an accident but, unlike the drivers, are not protected by a seat belt. Thus, a seat belt law tends to increase the number of pedestrian deaths.

At first, this discussion of incentives and seat belts might seem like idle speculation. Yet in a classic 1975 study, economist Sam Peltzman argued that car safety laws in the United States have, in fact, had many of these effects. According to Peltzman's evidence, US laws produced both fewer deaths per accident and more accidents. He concluded that the net result was little change in the number of driver deaths and an increase in the number of pedestrian deaths.

Peltzman's analysis of car safety is an offbeat and controversial example of the general principle that people respond to incentives. It implies that more recent changes to car safety laws, such as requiring air bags and advanced braking systems in new cars, may mean more deaths for pedestrians and cyclists. When analysing any policy, we must consider not only the direct effects but also the less obvious, indirect effects that work through incentives. If the policy changes incentives, it will cause people to alter their behaviour.

QUIZ

List and briefly explain the four lessons of individual decision making. Describe an important trade-off you recently faced. Describe an incentive your parents offered you in an effort to influence your behaviour.

CASE STUDY

Choosing when the stork comes

In the decade between 2004 and 2014, the Australian government made a payment to parents for every baby born. These payments were known as the 'baby bonus', and ranged in value between \$3000 and \$5437 across the lifetime of the scheme. The story of the baby bonus has lessons for how people respond to incentives and why governments (and others) need to anticipate these responses.

In May 2004, the then Treasurer, Peter Costello, announced a \$3000 payment (rising to

\$5000 in 2008) for every child born after 1 July 2004. This meant that the parents of someone whose birthday was 30 June 2004 or earlier would receive nothing. But hold off a day or so, and they would get \$3000. This created an incentive for parents to delay births if they could. And by agreeing with their doctors to schedule planned caesareans and inducements a little later, births could be moved.

The following graph shows what happened.

