

Microeconomics for MBAs

The Economic Way of Thinking for Managers

Richard B. McKenzie

Dwight R. Lee



CAMBRIDGE
UNIVERSITY PRESS

Short contents

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

Book V Behavioral economics: a challenge to conventional microeconomics	597
14 Challenges of behavioral economists	599
15 Problems with behavioral economics	632
Bibliography	676
Index	707

Contents

List of figures	page xviii
List of tables	xxi
Preface	xxiii
Video lectures and suggested uses	xxxiii
How to use this book in traditional, online, and hybrid courses	xxxvi
Book I The market economy, overview and application	1
1 Microeconomics: a way of thinking about business	3
Part A Theory and public policy applications	8
The emergence of a market	8
The economic problem	10
The scope of economics	13
Developing and using economic theories	14
Microeconomics and macroeconomics	16
Private property rights, game theory, and the Prisoner's Dilemma	17
Private property rights and the games economists play	18
Private property rights and the market	19
The emergence of private property rights	20
Game theory: Prisoner's Dilemmas	23
Prisoner's Dilemma solutions: enforcement and trade	24
Communal property rights and the "tragedy of the commons"	27
Voluntary organizations and firms as solutions for "tragedies of the commons"	32
The tragedy of the anticommons	33
Perspective 1 "I, Pencil," by Leonard E. Read	36
Part B Organizational economics and management	40
Managing through incentives	40
Productivity increases	41
The growing importance of incentives	42
The classic Lincoln Electric case study	42

Incentives and managed earnings	44
Why incentives are important	45
Practical lessons for serious business students	48
Further reading online	49
Recommended video lectures	49
The bottom line	49
Review questions	50
2 Principles of rational behavior in society and business	51
Part A Theory and public policy applications	53
Rationality: a basis for exploring human behavior	54
Rational decisions in a constrained environment	57
Maximizing satisfaction; cost–benefit analysis	60
The effects of time and risk on costs and benefits	62
What rational behavior does <i>not</i> mean	66
Perspective 2 The evolutionary foundations of cooperation	68
Part B Organizational economics and management	72
The logic of group behavior in business and elsewhere	72
The common-interest logic of group behavior	72
The economic logic of group behavior	74
Overcoming Prisoner’s Dilemmas through tough bosses	83
Take this job and ...	84
The role of the residual claimant in abating Prisoner’s Dilemmas in large groups	90
Practical lessons for serious business students	93
Further reading online	93
Recommended video lectures	93
The bottom line	94
Review questions	95
3 Competitive product markets and firm decisions	97
Part A Theory and public policy applications	99
The competitive market process	99
Supply and demand: a market model	102
Market equilibrium	111
The efficiency of the competitive market model	116

Nonprice competition	118
Competitive labor markets	124
Perspective 3 Why queues?	126
Part B Organizational economics and management	130
Making worker wages profitable in competitive markets	130
Henry Ford's "overpayment"	130
Overpayments to prevent misuse of firm resources	134
The underpayment and overpayment of workers	135
The overpayment/underpayment connection	136
Mandatory retirement	136
The role of employers' "credible commitments"	139
Practical lessons for serious business students	145
Further reading online	146
Recommended video lectures	146
The bottom line	146
Review questions	147
4 Applications of the economic way of thinking: domestic government and management policies	149
Part A Theory and public policy applications	150
Who pays the tax?	150
Price controls	153
The California drought and the effects of low and controlled water prices on conservation	157
Fringe benefits, incentives, and profits	161
Minimum wages	168
The draft versus the all-volunteer military service	176
Perspective 4 Maslow's Hierarchy of Needs and economists' supply and demand curves, contrasting views on human (and economic) choices	178
Part B Organizational economics and management	185
How honesty can pay in business	186
Game theory, again: games of trust	188
Moral hazards and adverse selection	190
The role of "hostages" in business	192
Firm logos	192
Storefronts and fixtures	193
Firm profitability	193

Creation of competition	193
Joint ownership	194
Guarantees	195
Practical lessons for serious business students	195
Further reading online	196
Recommended video lectures	196
The bottom line	196
Review questions	197
Book II Applications of basic economic theory	199
5 Applications of the economic way of thinking: international economics	201
Part A International trade theory and public policy applications	203
Global economics: international trade	203
Aggregate gains from trade	203
The law of comparative advantage	205
The distributional effects of trade	208
Gains to exporters	209
The effects of trade restrictions	210
Special interests' politics and trade restrictions	211
Protection retaliation and trade wars	212
Interconnections of comparative advantage	214
The Trade Authority Bill 2015	215
Perspective 5 "A PETITION From the Manufacturers of Candles, ... and Generally of Everything Connected with Lighting," by Frédéric Bastiat (1801–1850), <i>Sophismes économiques</i> , 1845	216
Part B International finance	219
The process of international monetary exchange	220
The exchange of national currencies	221
Determination of the exchange rate	223
Exchange rates and changes in domestic market conditions	225
Monetary and fiscal policies	227
Practical lessons for serious business students	229
Further reading online	229
Recommended video lectures	230
The bottom line	230
Review questions	230

6	Applications of the economic way of thinking: environmental economics	232
	Part A Green economics: external costs and benefits	233
	Competitive markets and environmental failures	234
	External costs	235
	External benefits	238
	The pros and cons of government action	240
	Methods of reducing externalities	241
	Choosing the most efficient remedy for reducing external costs of pollution	245
	Perspective 6 Why walking to work can be more polluting than driving to work	248
	Part B Organizational economics and management	253
	The consequences of “quicksilver capital” for business and government	253
	Capital mobility and business competitiveness	255
	Capital mobility and government competitiveness	255
	Collective agreement problems in averting global-warming Armageddon	258
	Practical lessons for serious business students	263
	Further reading online	264
	Recommended video lectures	264
	The bottom line	264
	Review questions	265
	Book III Demand and production theory	267
7	Consumer choice and demand in traditional and network markets	269
	Part A Theory and public policy applications	270
	Predicting consumer demand	270
	Rational consumption: the concept of marginal utility	271
	Changes in price and the law of demand	274
	From individual demand to market demand	276
	Elasticity: consumers’ responsiveness to price changes	277
	Applications of the concept of elasticity	282
	Determinants of the price elasticity of demand	285
	Changes in demand	286
	Normal and inferior goods	288

Substitutes and complementary goods	289
Acquisition and transactional utility	290
Objections to demand theory	291
Perspective 7 Common concerns relating to the law of demand	291
Part B Organizational economics and management	297
Pricing strategies and demand characteristics	297
Scarcity, abundance, and economic value	303
Software networks	303
Practical lessons for serious business students	306
Further reading online	307
Recommended video lectures	307
The bottom line	307
Review questions	308
8 Production costs and the theory of the firm	310
Part A Theory and public policy applications	312
Various cost conceptions	312
The special significance of marginal cost	316
The cost-benefit trade-off	320
Price and marginal cost: producing to maximize profits	323
From individual supply to market supply	324
Perspective 8 The last-period problem	325
Part B Organizational economics and management	333
Production costs and firms' size and organizational structure	333
Reasons for firms	335
Changes in organizational costs	342
Overcoming the large-numbers' Prisoner's Dilemma problems	344
Make-or-buy decisions	346
The value of reputation, again	350
The franchise decision	351
Practical lessons for serious business students	355
Further reading online	356
Recommended video lectures	356
The bottom line	357
Review questions	358

9	Production costs in the short run and long run	360
	Part A Theory and public policy applications	362
	Fixed, variable, and total costs in the short run	362
	Marginal and average costs in the short run	363
	Marginal and average costs in the long run	366
	Long-run average and marginal cost curves	368
	Industry differences in average cost	368
	Shifts in the average and marginal cost curves	371
	The very long run	372
	Perspective 9 Myth of the first-mover advantage	373
	Part B Organizational economics and management	376
	Firms' debt/equity structures and executive incentives	376
	Debt and equity as alternative investment vehicles	378
	Past failed incentives in the S&L industry	380
	Industry maturity and funds misuse	383
	Firm maturity and indebtedness	385
	The bottom-line consequences of firms' financial structures	385
	The emergence of the housing bubble and burst of the early 2000s	386
	The bailout and stimulus policy debate, for and against	395
	Lessons learned from the housing and economic crisis?	397
	Practical lessons for serious business students	399
	Further reading online	399
	Recommended video lecture	399
	The bottom line	400
	Review questions	401
	Book IV Competitive and monopoly market structures	403
10	Firm production under idealized competitive conditions	405
	Part A Theory and public policy applications	406
	Pricing and production strategies under four market structures	407
	The perfect competitor's production decision	411
	Maximizing short-run profits	414
	Minimizing short-run losses	416

Producing over the long run	418
Marginal benefit versus marginal cost	421
The efficiency of perfect competition: a critique	423
Price takers and price searchers	426
The perfection in perfect competition?	428
Perspective 10 The “innovator’s dilemma”	430
Part B Organizational economics and management	436
Competing cost-effectively through efficient teams	436
Team production	437
Paying teams	441
Experimental evidence on the effectiveness of team pay	443
Practical lessons for serious business students	445
Further reading online	447
Recommended video lectures	447
The bottom line	447
Review questions	448
11 Monopoly power and firm pricing decisions	450
Part A Theory and public policy applications	452
The origins of monopoly	452
The limits of monopoly power	454
Equating marginal cost with marginal revenue	458
The comparative inefficiency of monopoly	461
Monopoly profits	463
Price discrimination	465
Applications of monopoly theory	470
The total cost of monopoly	472
Durable goods monopoly	475
Monopoly in government and inside firms	476
Perspective 11 The QWERTY keyboard: a case of “lock-in”?	478
Part B Organizational economics and management	481
Profits from creative pricing	481
Price discrimination in practice	481
Pricing cartels	487
Practical lessons for serious business students	493
Further reading online	494
Recommended video lectures	494

The bottom line	495
Review questions	496
Appendix: short-run profits and losses	498
The bottom line	501
Review questions	501
12 Firm strategy under imperfectly competitive market conditions	502
Part A Theory and public policy applications	504
Monopolistic competition	505
Oligopoly	509
Cartels: incentives to collude and to cheat	513
Game theory: cartels and the Nash equilibrium	515
The case of the natural monopoly	518
The economics and politics of business regulation	520
Perspective 12 Pedophiles and the regulation of hugging, with Kathryn Shelton	526
Part B Organizational economics and management	533
“Hostile” takeover as a check on managerial monopolies	533
Reasons for takeovers	534
The market for corporate control	534
The efficiency of takeovers	537
Will monopoly profits last into the very long run?	543
Practical lessons for serious business students	544
Further reading online	546
Recommended video lectures	546
The bottom line	546
Review questions	547
13 Competitive and monopsonistic labor markets	549
Part A Theory and public policy applications	551
The demand for and supply of labor	551
Why wage rates differ	557
Overtime pay, an unmitigated benefit for covered workers?	562
Monopsonistic labor markets	563
Employer cartels: monopsony power through collusion	568
Monopsony and the minimum wage	569
Perspective 13 Why professors have tenure and businesspeople don't	570

Part B Organizational economics and management	578
Paying for performance	578
When managers can change the rate of piece-rate pay	586
Two-part pay systems	587
Why incentive pay equals higher pay	588
One-time bonuses versus annual raises	591
Practical lessons for serious business students	592
Further reading online	593
Recommended video lectures	593
The bottom line	594
Review questions	595
Book V Behavioral economics: a challenge to conventional microeconomics	597
14 Challenges of behavioral economists	599
Part A The overall dimensions of the behavioral challenge	600
Prospect theory	604
Dominance and invariance	609
Mental accounting	611
Endowment effect	613
Acquisition and transaction utility	616
The matter of sunk costs	617
Perspective 14 Neuroeconomics, by Paul J. Zak	619
Part B Behavioral finance	620
The efficient-market hypothesis, again	620
Behaviorists' objections to conventional finance theory	621
Further reading online	629
The bottom line	629
Review questions	630
15 Problems with behavioral economics	632
Part A Concerns with basic principles of behavioral economics	633
The perfect rationality caricature	633
Reliance on constrained laboratory studies	640

The human brain's internal inclination to correct errant decisions	642
Ecologically adaptive environments	645
Subjects' overall rationality	646
Errant decisions, entrepreneurs, and market pressures	650
The rational emergence of choice options	655
Perspective 15 NBC's anchor Brian Williams' fall from grace, "false memory," and incentives	656
Part B "Nudges" and their problems	661
Proposed nudges	661
Problems with nudges	666
From nudges to mandates: the slippery slope	670
Further reading online	673
Recommended video lecture	673
The bottom line	673
Review questions	675
Bibliography	676
Index	707