Readings in Applied Microeconomics

A central concern of economics is how society allocates its resources. Modern economies rely on two institutions to allocate: markets and governments. But how much of the allocating should be performed by markets and how much by governments? This collection of readings will help students appreciate the power of the market. It supplements theoretical explanations of how markets work with concrete examples, addresses questions about whether markets actually work well and offers evidence that supposed "market failures" are not as serious as claimed.

Featuring readings from Hayek, William Baumol, Harold Demsetz, Daniel Fischel and Edward Lazear, Benjamin Klein and Keith B. Leffler, Stanley J. Liebowitz and Stephen E. Margolis, and John R. Lott, Jr., this book covers key topics such as:

- Why markets are efficient allocators
- How markets foster economic growth
- Property rights
- How markets choose standards
- Asymmetric Information
- Whether firms abuse their power
- Non-excludable goods
- Monopolies

The selections should be comprehended by undergraduate students who have had an introductory course in economics. This reader can also be used as a supplement for courses in intermediate microeconomics, industrial organization, business and government, law and economics, and public policy.

Craig M. Newmark is Associate Professor of Economics at North Carolina State University, USA. His research focuses on U.S. antitrust policy and has been published in the Journal of Political Economy, Journal of Law and Economics, Review of Economic Statistics, and other journals. He teaches graduate courses in microeconomics and writing for economists, and an undergraduate course on the moral foundations of capitalism.

Readings in Applied Microeconomics

The Power of the Market

Edited by

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To my wife, Betsy, and to my children, Katie and Meredith

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Preface

A central concern of economics is how society allocates its resources. Modern economies rely on two institutions to allocate: markets and governments. But how much of the allocating should be performed by markets and how much by governments?

In economics classes students learn—in a rather abstract way—that markets are generally good allocators. They are also taught that in some instances markets do not work well and that in these instances of "market failure," including externalities, non-excludable goods, asymmetric information, and monopoly, allocation by government is better. But even before the instructor discusses market failure, students typically question whether markets work well. Do they work well if companies become large? Won't large companies exploit their "power"? If markets work well, why are people forced to use inferior products such as Windows software? Won't market exploitation of vital natural resources, such as oil, cause us to run out? How can markets work well if information is costly? How can consumers trust what firms tell them?

As I write this in October 2008, concerns about the market system are especially intense. But people have always feared and suspected markets. Markets—and the idea of capitalism—don't inspire loyalty or love like other ideas. Peter Saunders wrote:

> Capitalism lacks romantic appeal. It does not set the pulse racing in the way that opposing ideologies like socialism, fascism, or environmentalism can. It does not stir the blood, for it identifies no dragons to slay. It offers no grand vision for the future, for in an open market system the future is shaped not by the imposition of utopian blueprints, but by billions of individuals pursuing their own preferences.
>
> Peter Saunders, "Why Capitalism is Good for the Soul," *Policy*, 23, 4 (Summer 2007–8, pp. 3–9)

This collection of readings is intended to address that problem. The book will help students appreciate the power of the market. It supplements theoretical explanations of how markets work with concrete examples. It addresses questions about whether markets actually work well. And it offers evidence that supposed "market failures" are not as serious as claimed.

Over one-third of the readings focus on vital aspects of markets that are insufficiently stressed in economics courses. Part one of the book looks at how market prices efficiently aggregate and transmit information while simultaneously also providing individuals with incentives to take good actions, good for both themselves and society. Part two readings look at how and why markets create wealth. Part three reminds students that property rights are important to the market system.

The other parts of the book present more standard topics but from a perspective that differs from the one undergraduate students usually see. Sections on externalities, non-excludable goods, and asymmetric information demonstrate that these problems are not as serious, or as common, as introductory textbooks imply. The readings in part seven on monopoly and collusion indicate even if a market has a small number of sellers, monopolistic behavior does not necessarily result. Finally, part eight's readings demonstrate that often-alleged abuses of firm power are powerfully constrained by the market.

Virtually every selection included in this book contains a story or a concrete example of the power of the market. The selections are non-technical, use almost no math, and should be comprehended by college students who have had an introductory course in economics. (It would be helpful if the students have also had introductory statistics up to basic regression analysis. Eight of the articles report regression results. But even if students haven't had statistics, I believe they will readily grasp the main points of those articles.) I have assigned many of these articles in undergraduate courses in microeconomics and industrial organization with success.

Each section begins with an introduction. Review and discussion questions follow each reading. And each section ends with some annotated suggestions for further readings. This reader can be used as a supplement in courses in intermediate microeconomics, industrial organization, business and government, and public policy.

I thank my editors at Routledge, Rob Langham and Emily Senior, for their encouragement and help. I thank my colleagues at North Carolina State University for their support and kindness. And, as always, I thank my wonderful family for everything: my wife, Betsy, and my two daughters, Katie and Meredith.