

## 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

**Craig M. Newmark**

 **Routledge**  
Taylor & Francis Group  
LONDON AND NEW YORK

First published 2009  
by Routledge  
2 Park Square, Milton Park, Abingdon, Oxon, OX14 4RN

Simultaneously published in the USA and Canada  
by Routledge  
270 Madison Avenue, New York, NY 10016

*Routledge is an imprint of the Taylor & Francis Group,  
an informa business*

© 2009 selection and editorial matter; Craig Newmark,  
individual chapters; the contributors

Typeset in Perpetua and Bell Gothic by Keyword Group Ltd  
Printed and bound in Great Britain by

All rights reserved. No part of this book may be reprinted or reproduced  
or utilised in any form or by any electronic, mechanical, or other means,  
now known or hereafter invented, including photocopying and recording,  
or in any information storage or retrieval system, without permission in  
writing from the publishers.

*British Library Cataloguing in Publication Data*  
A catalogue record for this book is available from the British Library

*Library of Congress Cataloging in Publication Data*

ISBN

HB 978-0-415-77739-1  
PB 978-0-415-77740-7  
EB 978-0-203-87846-0

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

# Contents

|                              |             |
|------------------------------|-------------|
| <i>Notes on Contributors</i> | <i>xi</i>   |
| <i>Acknowledgements</i>      | <i>xiii</i> |
| <i>Preface</i>               | <i>xvii</i> |

## **PART ONE** **Information and Incentives**

|   |           |
|---|-----------|
| <b>1 F. A. Hayek</b>  | <b>4</b>  |
| THE USE OF KNOWLEDGE IN SOCIETY   |           |
| <b>2 Leonard H. Read</b>  | <b>14</b> |
| I, PENCIL   |           |
| <b>3 Charles Maurice and Charles W. Smithson</b>  | <b>19</b> |
| THE TIMBER CRISIS<br>AND<br>AMERICA'S FIRST OIL CRISIS  |           |
| <b>4 Steven Horwitz</b>   | <b>38</b> |
| MAKING HURRICANE RESPONSE MORE EFFECTIVE:<br>LESSONS FROM THE PRIVATE SECTOR AND THE COAST GUARD DURING KATRINA |           |
| <b>5 Michael T. Maloney and J. Harold Mulherin</b>  | <b>61</b> |
| THE COMPLEXITY OF PRICE DISCOVERY IN AN EFFICIENT MARKET:<br>THE STOCK MARKET REACTION TO THE CHALLENGER CRASH  |           |

**PART TWO**  
**Creating Value**

|           |  |            |
|-----------|--|------------|
| <b>6</b>  | <b>William J. Baumol</b>                                       | <b>91</b>  |
|           | ENTREPRENEURSHIP: PRODUCTIVE, UNPRODUCTIVE, AND DESTRUCTIVE    |            |
| <b>7</b>  | <b>Ronald Bailey</b>   | <b>115</b> |
|           | THE LAW OF INCREASING RETURNS                                  |            |
| <b>8</b>  | <b>Russell Roberts</b>   | <b>124</b> |
|           | THE GREAT OUTSOURCING SCARE OF 2004                            |            |
| <b>9</b>  | <b>Geoffrey Colvin</b>   | <b>128</b> |
|           | WE'RE WORTH OUR WEIGHT IN PENTIUM CHIPS                        |            |
| <b>10</b> | <b>W. Michael Cox and Richard Alm</b>                          | <b>131</b> |
|           | THESE ARE THE GOOD OLD DAYS: A REPORT OF U.S. LIVING STANDARDS |            |

**PART THREE**  
**Property Rights**

|           |  |            |
|-----------|--|------------|
| <b>11</b> | <b>Harold Demsetz</b>  | <b>157</b> |
|           | TOWARD A THEORY OF PROPERTY RIGHTS   |            |
| <b>12</b> | <b>Robert C. Ellickson</b>   | <b>169</b> |
|           | A HYPOTHESIS OF WEALTH-MAXIMIZING NORMS: EVIDENCE<br>FROM THE WHALING INDUSTRY |            |
| <b>13</b> | <b>Michael Satchell</b>  | <b>183</b> |
|           | SAVE THE ELEPHANTS: START SHOOTING THEM  |            |

**PART FOUR**  
**Externalities and Coordination Problems**

|           |   |            |
|-----------|---|------------|
| <b>14</b> | <b>Michael C. Munger</b>  | <b>192</b> |
|           | ORANGE BLOSSOM SPECIAL: EXTERNALITIES AND THE COASE THEOREM                         |            |
| <b>15</b> | <b>Fred E. Foldvary and Daniel B. Klein</b>   | <b>197</b> |
|           | THE HALF-LIFE OF POLICY RATIONALES: HOW NEW<br>TECHNOLOGY AFFECTS OLD POLICY ISSUES |            |
| <b>16</b> | <b>S. J. Liebowitz and Stephen E. Margolis</b>                                      | <b>208</b> |
|           | THE FABLE OF THE KEYS   |            |

## **PART FIVE**

### **Non-Excludable Goods**

- |    |   |     |
|----|---|-----|
| 17 | John R. Lott, Jr.                           | 233 |
|    | COMMERCIALIZATION OF RADIO                  |     |
| 18 | Daniel B. Klein                             | 235 |
|    | PRIVATE HIGHWAYS IN AMERICA, 1792–1916      |     |
| 19 | Richard L. Stroup                           | 241 |
|    | FREE RIDERS AND COLLECTIVE ACTION REVISITED |     |

## **PART SIX**

### **Asymmetric Information**

- |    |  |     |
|----|--|-----|
| 20 | Benjamin Klein and Keith B. Leffler                                    | 259 |
|    | THE ROLE OF MARKET FORCES IN ASSURING CONTRACTUAL PERFORMANCE          |     |
| 21 | Clement G. Krouse  | 279 |
|    | BRAND NAME AS A BARRIER TO ENTRY: THE REALEMON CASE                    |     |
| 22 | Steven N. Wiggins and David G. Raboy                                   | 289 |
|    | PRICE PREMIA TO NAME BRANDS: AN EMPIRICAL ANALYSIS                     |     |
| 23 | John R. Lott, Jr.  | 299 |
|    | A SOUR LEMON STORY   |     |
| 24 | Eric W. Bond   | 303 |
|    | A DIRECT TEST OF THE "LEMONS" MODEL: THE MARKET FOR USED PICKUP TRUCKS |     |

## **PART SEVEN**

### **Monopoly and Collusion**

- |    |  |     |
|----|--|-----|
| 25 | David Hemenway   | 313 |
|    | THE ICE TRUST  |     |
| 26 | Harold Demsetz   | 326 |
|    | INDUSTRY STRUCTURE, MARKET RIVALRY, AND PUBLIC POLICY  |     |
| 27 | Craig M. Newmark   | 334 |
|    | DOES HORIZONTAL PRICE FIXING RAISE PRICE? A LOOK AT THE BAKERS OF WASHINGTON CASE                  |     |
| 28 | Craig M. Newmark   | 349 |
|    | PRICE AND SELLER CONCENTRATION IN CEMENT: EFFECTIVE OLIGOPOLY OR MISSPECIFIED TRANSPORTATION COST? |     |

X CONTENTS

**PART EIGHT**  
**Abuse of Firm Power**

|   |            |
|---|------------|
| <b>29 Eugene Silberberg</b>   | <b>361</b> |
| SHIPPING THE GOOD APPLES OUT  |            |
| <b>30 Daniel R. Fischel and Edward P. Lazear</b>                      | <b>366</b> |
| COMPARABLE WORTH AND DISCRIMINATION IN LABOR MARKETS                  |            |
| <b>31 Harold Demsetz and Kenneth Lehn</b>                             | <b>383</b> |
| THE STRUCTURE OF CORPORATE OWNERSHIP: CAUSES<br>AND CONSEQUENCES      |            |
| <b>32 Charles R. Knoeber</b>  | <b>402</b> |
| GOLDEN PARACHUTES, SHARK REPELLENTS, AND HOSTILE<br>TENDER OFFERS     |            |
| <b>33 Benjamin Klein</b>  | <b>419</b> |
| TRANSACTION COST DETERMINANTS OF "UNFAIR" CONTRACTUAL<br>ARRANGEMENTS |            |
| <b>34 John R. Lott, Jr.</b>   | <b>428</b> |
| TWO EXCEPTS FROM FREEDOMNOMICS  |            |



## Notes on Contributors

**Richard Alm** is Senior Economics Writer at the Federal Reserve Bank of Dallas.

**Ronald Bailey** is Science Editor at *Reason* magazine.

**William J. Baumol** is Professor of Economics and Director of the C.V. Starr Center for Applied Economics at New York University and Senior Research Economist and Professor of Economics, Emeritus, Princeton University. He is a past president of the American Economic Association (1981).

**Eric W. Bond** is the Joe Roby Professor of Economics at Vanderbilt University.

**Geoffrey Colvin** is Senior Editor-at-Large at *Fortune* magazine.

**W. Michael Cox** is Senior Vice President and Chief Economist at the Federal Reserve Bank of Dallas.

**Harold Demsetz** is Professor Emeritus of Economics at the University of California, Los Angeles.

**Robert C. Ellickson** is the E. Meyer Professor of Property and Urban Law at the Yale Law School.

**Daniel R. Fischel** is the Lee and Brena Freeman Professor of Law and Business, Emeritus at the University of Chicago Law School.

**Fred E. Foldvary** is a lecturer in economics at Santa Clara University and a research fellow at the Independent Institute.

**F. A. Hayek** shared the Nobel Prize in Economics in 1974. He died in 1992.

**David Hemenway** is Professor of Health Policy at the Harvard School of Public Health and Director of the Harvard Injury Control Research Center and the Harvard Youth Violence Prevention Center.

**Steven Horwitz** is Charles A. Dana Professor of Economics at St. Lawrence University.

**Benjamin Klein** is Professor Emeritus of Economics at the University of California, Los Angeles and Director, LECC.

- Daniel B. Klein** is Professor of Economics at George Mason University.
- Charles R. Knoeber** is Professor of Economics at North Carolina State University.
- Clement G. Krouse** is Professor of Economics at the University of California at Santa Barbara.
- Edward P. Lazear** is the Steele Parker Professor of Human Resources Management and Economics at Stanford University and the Morris Arnold Cox Senior Fellow at the Hoover Institution. He served as the Chairman of the U.S. Council of Economic Advisors from 2006 to 2009.
- Keith B. Leffler** is Associate Professor of Economics at the University of Washington.
- Kenneth Lehn** is Samuel A. McCullough Professor of Finance at the Katz Graduate School of Business of the University of Pittsburgh.
- S. J. Liebowitz** is the Ashbel Smith Professor of Economics at the University of Texas at Dallas.
- John R. Lott, Jr.** is Senior Research Scientist at the University of Maryland Foundation.
- Michael T. Maloney** is Professor of Economics at Clemson University.
- Stephen E. Margolis** is Professor of Economics at North Carolina State University.
- Charles Maurice** was Professor Emeritus of Economics at Texas A & M University. He died in 1999.
- J. Harold Mulherin** is Professor of Banking and Finance at the University of Georgia.
- Michael C. Munger** is Professor of Political Science, Economics, and Public Policy at Duke University. He served as President of the Public Choice Society and as North American editor of *Public Choice*.
- Craig M. Newmark** is Associate Professor of Economics at North Carolina State University.
- David G. Raboy** is Chief Economic Consultant at Patton Boggs LLP.
- Leonard E. Read** was the founder of the Foundation for Economics Education. He died in 1983.
- Russell Roberts** is Professor of Economics at George Mason University, the J. Fish and Lillian F. Smith Distinguished Scholar at the Mercatus Center, and a research fellow at Stanford University's Hoover Institution.
- Michael Satchell** is a writer at *U.S. News & World Report*.
- Eugene Silberberg** is Professor Emeritus of Economics, University of Washington.
- Charles W. Smithson** is a Partner with Rutner Associates, New York, NY.
- Richard L. Stroup** is Adjunct Professor of Economics at North Carolina State University and an Adjunct Scholar at the Cato Institute.
- Steven N. Wiggins** is Professor of Economics at Texas A & M University.

## 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.