

## Contents

Message to students	xi
Preface	xiii
Acknowledgments	xvii
Publisher's acknowledgments	xix
<b>Part I</b>	<b>Economic Principles</b>
<b>Chapter 1</b>	<b>Economic building blocks and the importance of elasticities</b> <b>3</b>
1.1	Introduction 3
1.2	What is an economy? 5
1.3	Building blocks of an economy 7
1.4	Elasticities 8
1.5	Positive and normative economics 13
1.6	Mathematical tools 14
1.7	Summary 18
	Exercises 18
	References 19
<b>Chapter 2</b>	<b>Scarcities and how they are priced</b> <b>21</b>
2.1	Introduction 21
2.2	The economy 22
2.3	Math review: Maximization of a function 23
2.4	Optimizing the economy 25
2.5	The theory of constrained optimization 29
2.6	Applying Lagrangian theory to the economy 34
2.7	Summary 36
	Exercises 37
	Reference 37
<b>Part II</b>	<b>The Demand Side of the Economy</b>
<b>Chapter 3</b>	<b>Utility and expenditures</b> <b>41</b>
3.1	Introduction 41
3.2	Utility functions 42
3.3	Revealed preferences 45

3.4	Demand and expenditure	48
3.5	CES functions	50
3.6	Quantities, prices, and the standard of living	53
3.7	Price indices	55
3.8	Summary	61
	Exercises	62
	References	62
<b>Chapter 4</b>	<b>Demand: Income and substitution effects</b>	<b>63</b>
4.1	Introduction	63
4.2	Compensated demand and Shephard's Lemma	66
4.3	Price effects on demand: The Slutsky equation	71
4.4	The Law of Demand for markets	75
4.5	Roy's Lemma	76
4.6	Intertemporal consumption: Savings	77
4.7	Demand for leisure time: Labor supply	80
4.8	Summary	82
	Exercises	83
	References	83
<b>Chapter 5</b>	<b>Measuring consumer well-being</b>	<b>85</b>
5.1	Introduction	85
5.2	Exact measures of price changes	86
5.3	Consumer surplus	89
5.4	Quasi-linear demand	92
5.5	Constant elasticity of substitution (CES) demand	93
5.6	Income changes	96
5.7	Aggregation	98
5.8	Summary	100
	Exercises	100
	References	101
<b>Part III</b>	<b>The Supply Side of the Economy</b>	
<b>Chapter 6</b>	<b>Production analysis: Inputs, outputs, coefficients, and productivity</b>	<b>105</b>
6.1	Introduction	105
6.2	Accounting for inputs and outputs	106
6.3	Productivity, profit, and value-added	107
6.4	National income and national product	109
6.5	Input–output analysis	110
6.6	Total factor productivity	113
6.7	Technical change	115

6.8	Summary	118
	Exercises	118
	References	119
<b>Chapter 7</b>	<b>Production functions</b>	<b>121</b>
7.1	Introduction	121
7.2	Cobb–Douglas and Leontief functions	122
7.3	Derivation of the Cobb–Douglas function	124
7.4	Two-stage production and marginal rates of substitution	126
7.5	Returns to scale	128
7.6	Summary	132
	Exercises	132
	Appendix 7.A: Derivation of the Cobb–Douglas function	133
	Appendix 7.B: Proof of the Functional Separability Theorem	134
	References	135
<b>Chapter 8</b>	<b>Supply and market power</b>	<b>137</b>
8.1	Introduction	137
8.2	Cobb–Douglas supply and demand	138
8.3	The production possibility set	141
8.4	Returns to scale	143
8.5	The Law of Supply	147
8.6	Hotelling’s Lemma	149
8.7	Production costs and input demand	149
8.8	Market power	152
8.9	Summary	155
	Exercises	156
	Reference	156
<b>Part IV</b>	<b>Building the Model of the Economy</b>	
<b>Chapter 9</b>	<b>Equilibrium</b>	<b>159</b>
9.1	Introduction	159
9.2	Homogeneity and Walras’ Law	161
9.3	Determining equilibrium: The analytical approach	163
9.4	Determining equilibrium: The graphical approach	164
9.5	The road to Negishi’s method: The contract curve	167
9.6	Determining equilibrium: Negishi’s method	168
9.7	General equilibrium analysis	170
9.8	Equilibrium analysis of production economies	176
9.9	Alternative utility and production functions in the general equilibrium model	179
9.10	Summary	181
	Exercises	181

	Appendix 9.A: Exchange Economies: Equilibrium Existence	183
	Appendix 9.B: Production Economies: Equilibrium Existence	186
	References	188
<b>Chapter 10</b>	<b>Efficiency theory</b>	<b>191</b>
	10.1 Introduction	191
	10.2 The First Welfare Theorem	192
	10.3 The Second Welfare Theorem	194
	10.4 Distinguishing between efficiency and inefficiency	196
	10.5 How to determine inefficiency	197
	10.6 Measuring inefficiency	200
	10.7 Inefficiency in small, open economies	202
	10.8 Summary	205
	Exercises	206
	Reference	206
<b>Part V</b>	<b>Putting the Model to Use</b>	
<b>Chapter 11</b>	<b>Measuring economic performance</b>	<b>209</b>
	11.1 Introduction	209
	11.2 Measuring performance by tracking consumption	210
	11.3 Analyzing dynamic efficiency	213
	11.4 Analyzing static efficiency	218
	11.5 Consumer surplus and market power	220
	11.6 Summary	223
	Exercises	223
	References	224
<b>Chapter 12</b>	<b>Market forms and competition policy</b>	<b>225</b>
	12.1 Introduction	225
	12.2 Sustainable and supportable prices	226
	12.3 Ramsey prices	229
	12.4 The Weak Invisible Hand Theorem	231
	12.5 Limit prices	232
	12.6 Measuring efficiency	234
	12.7 Measuring the efficiency of an industrial organization	240
	12.8 Efficiency and prices	243
	12.9 Summary	243
	Exercises	244
	References	244
<b>Chapter 13</b>	<b>Public economics</b>	<b>247</b>
	13.1 Introduction	247
	13.2 Public goods	249

13.3	Lindahl prices	252
13.4	Ramsey taxes	256
13.5	Club goods	258
13.6	Externalities	260
13.7	Environmental economics	262
13.8	Measuring inequality	265
13.9	Summary	270
	Exercises	271
	References	272
<b>Part VI</b>	<b>Market Imperfections</b>	
<b>Chapter 14</b>	<b>Game theory and the new industrial organization</b>	<b>275</b>
14.1	Introduction	275
14.2	Games and strategies: Best responses	276
14.3	Price games	277
14.4	Quantity games	280
14.5	The new industrial organization	281
14.6	Bimatrix games	284
14.7	Randomized strategies	286
14.8	Nash equilibrium analysis	287
14.9	Constant-sum games	288
14.10	Summary	293
	Exercises	293
	References	294
<b>Chapter 15</b>	<b>Analyzing uncertainty and missing information</b>	<b>295</b>
15.1	Introduction	295
15.2	Modeling uncertainty	295
15.3	Expected utility theory	299
15.4	Risk analysis	304
15.5	Contingencies analysis	307
15.6	Insurance	310
15.7	Fixed wages vs. bonuses	311
15.8	Summary	312
	Exercises	313
	References	314
<b>Chapter 16</b>	<b>Search, transaction, and switching costs</b>	<b>315</b>
16.1	Introduction	315
16.2	Searching: Analyzing costs vs. benefits	315
16.3	Transaction costs	320
16.4	Switching costs	321
16.5	Summary	325

Exercises	325
Appendix 16.A: Differentiating the integral in the expected utility expression with respect to the number of searches	326
References	326
Appendix: Answers	329
Index	341

# 1

## **Economic building blocks and the importance of elasticities**

### **1.1 Introduction**

Some argue that economics stands out among the social sciences because of its precise and measurable nature – quite different (economists like to think) from many of the other social sciences, such as psychology and sociology. Indeed, the objects of economics – whether they be costs, market prices, quantities traded, or any other transaction between individuals – lend themselves to quantitative analysis. For instance, there are disparities in the observable costs of different goods and services, and these affect which items are in great demand and which are not. Take income, which varies between countries and individuals. Even when things cannot be expressed directly in monetary values, such as the damage inflicted by pollution, economists measure other quantities (for example, in tons of emissions) and propose monetary equivalents for compensating damages. Such quantification is possible because transactions between producers and consumers are measurable, at least in principle, which cannot be said of other social sciences.

In this chapter we identify the building blocks of the economic model that will be introduced in Chapter 2 and refined thereafter in subsequent chapters. Economics has many subdisciplines, including monetary economics, international trade, environmental economics, business economics, public economics, health economics and industrial organization, but a division is usually drawn between *microeconomics* and *macroeconomics*. Their interrelationship is key to our approach in this book. Macro, for short, is concerned with economic aggregates, such as the level of unemployment, the price level, the quantity of money, and the rate of productivity growth. However, it has probably become abundantly clear during your studies that an understanding of these issues requires knowledge of microeconomics. For example, the price “level” is an average of many different prices in an economy – so we had better understand the formation and role of each of them before we start working with some weighted average. Microeconomics is the foundation of economics. It explains the magnitude of economic transactions using data describing the following three

fundamentals: consumers' preferences, the limits of technology, and available physical resources. This three-way approach pervades all branches of economics and can even be applied beyond the discipline: the tools of microeconomic analysis are used in many interdisciplinary sciences, including ecology, marketing, and conflict analysis.

In microeconomics we study the behavior of interdependent consumers and producers. Consumers supply labor and capital and demand goods and services for consumption. Producers are the mirror image, demanding labor and capital and, in return, supplying produced goods and services. The fact that producers also use produced goods and services compounds the degree of interdependence. Moreover, many (if not all) produced goods and services, such as electricity, computers, buildings, and cleaning services, are used by both consumers and producers. The economy can be thought of as a remarkable machine that coordinates all these demands and supplies. An understanding of this machine requires a thorough knowledge of its constituent parts – consumers and producers – and the coordination mechanism. Like a car, an economy consists of many parts. But, rather than having a driver, an economy's parts – the correct supply of fluids, maintenance, and other goods and services – are coordinated by *markets*, where prices vary to match demand and supply.

It is particularly important to understand these interdependencies when addressing economic policy issues. For instance, economists advocate free trade even when it constitutes a threat to domestic businesses. The European Union is a free-trade zone, and free-trade agreements among non-member countries are an even more common example of threats to domestic industry. The negotiations that precede such arrangements involve scenario analyses that assess the pros and the cons of free trade. In order to understand which domestic products will be out-competed by imports and, conversely, which products will be produced in greater quantities for export to new markets, we must be able to determine the supplies and demands that will prevail under a particular free-trade arrangement. The new imports and new exports are interdependent because national economies pay for their imports with their exports. So we need an economic model to help us understand these relationships and determine whether or not citizens will be better off in the new situation (as economists suggest), and whether the new situation will be “efficient.” In this book we extend this economic analysis to environmental policy. For example, we will see that the Netherlands has a relatively clean pattern of consumption but not of production. By exporting products, the Dutch import pollution. If the Dutch take over production from Germany, for instance, Dutch exports increase but, at the same time, pollution is relocated from Germany to the Netherlands. It is efficient if some countries, with relatively clean production, pollute more than others. Indeed, as one country's living standard gains from trade, the environment may gain from specialization in relatively clean production.

Interdependencies also play a role at a more micro level. When energy suppliers overcharge, not only do household electricity bills increase but other goods and

services that must be purchased are also affected, since electricity is an input to all produced commodities and thus codetermines their prices. What is the right electricity price? This question must be answered on the basis of an efficiency criterion – namely, that citizens cannot be better off – and we will learn how to determine the efficient price. However, this is not easy. The prices of many goods and services cannot be determined without knowledge of the price of electricity. For instance, electricity is used to produce cables, but cables are used to produce electricity. We will develop a general equilibrium model that accommodates roundabout production. Roundaboutness is excluded from standard microeconomic textbooks but here it is an integral part of the discussion of microeconomic theory. The first main result is the construction of market-clearing equilibrium prices; the other two are welfare theorems. The First Welfare Theorem shows that the equilibrium allocation is efficient, while the second shows that any other efficient allocation can be brought about by a combination of wealth redistribution and the market mechanism.

Overcharging, an instance of the abuse of market power, raises a number of interesting questions. First and foremost, what is market power? In its pure form you may think it is monopoly power, unhindered by competition; but this is not true. A monopoly may actually have little power. For instance, some telephone services are provided by a single carrier, but, if the incumbent overcharges, a potential entrant may take over. Thus, we define monopoly power as the ability to raise price above cost. Here it is important to note that the determination of cost is also an issue that requires much information and, once again, an economic model. Second, is market power bad? In order to answer this question we must relate market power to inefficiency. Third, when should we be on the look-out for market power? A low number of firms in an industry is not a sufficient indicator of market power. Demand plays a significant role, too. If customers have substitutes it is difficult to exercise market power because elastic demands counter anti-competitive behavior. Last, but not least, the conduct of producers may be collusive. All these issues will be dealt with and quantified using an economic model that we will construct. We will see, for example, that at the turn of the millennium Spanish airlines appeared to compete, even though their rates were not much lower than those a cartel might have set. In the real world, other departures from efficient competitive outcomes are the rule, rather than the exception. From a policy point of view, it is interesting to measure the gap between price and cost – not only in price but also in terms of consumers' valuations. The distinctive feature of the model we develop later in this book is that all the key concepts are measurable.

## 1.2 What is an economy?

The analysis of equilibrium and efficiency presented here will be more formal than analysis you have seen before, and therefore we must be more formal in

defining the subject of our analysis. As in any science, it is extremely important to clearly distinguish what is considered given and what has still to be explained. The variables that are considered given are called *exogenous* variables, and the variables that have to be explained are called *endogenous* variables. Economists analyze the behavior of consumers, with consumers' preferences for consumption goods, services, and leisure time, as well as consumers' initial resources, as givens. Resources include not only any goods they inherit but also the skills they were given at birth and by upbringing. All these are exogenous variables. Clearly, though, the consumers' preferences are not simply "given" but also are shaped by their exposure to advertisements and social interactions. Economists recognize this, but their focus is not on explaining *why* people have particular tastes: This is left to psychologists and cultural anthropologists.

Economists also analyze producers' behavior, using the technological possibilities available to them. Technology is also exogenous, though it is always changing and, thus, not a "given." For example, we cannot take for granted the possible methods of making power (for example, coal, oil, nuclear, or solar), since so much effort is directed toward expanding these possibilities. Therefore economists leave it to engineers to delineate the state of the art.

What economists consider to be given – the exogenous variables of preferences, resources, and technology – are the building blocks of an economy, or *fundamentals*. Through the interaction between households and firms (and possibly other actors), the fundamentals determine *outcomes*, which are the endogenous variables that we seek to explain. These include the quantities of all goods and services produced and consumed, as well as their prices. It is important to grasp the direction of economic reasoning, which moves from fundamentals to outcomes. Many people, including economists, are confused about this.

A simple example will help to illustrate the issue. A number of people have failed their driving test several times and have given up. Now let us ask them, "Which car would you prefer to drive, a Bentley or a Volkswagen?" Many students assume the answer would be "A Bentley" because that is the more valuable car. But why is it more valuable? The answer is that other people – those *with* a driving permit – prefer to drive a Bentley rather than a Volkswagen. Now imagine that the world is populated *only* with non-drivers. In such a world, each person would judge the two cars on the basis of the cars' intrinsic values; but, having no license to drive, they would be indifferent. Thus, a Bentley would be as valueless as a Volkswagen. So this "preference" for the Bentley is misleading because it is based on the car's market price. As microeconomists, we want to explain the car's market price on the basis of consumers' intrinsic preferences and resources, as well as the car's technology. If we make one of the fundamental economic building blocks – namely, consumers' preferences – dependent on something else we want to explain – that is, the endogenous variable, price – our analysis becomes a mess of circular reasoning. For this reason, we must define preferences *irrespective* of price on the basis of the physical characteristics of goods and services.

Sensible policymaking requires a systematic mode of economic reasoning. First and foremost, we need theory to sort out what we want to explain – such as the standard of living – and which variables we will use for our investigation – such as the available means of production or rules of behavior. Then we need an economic model to quantify these relationships. The model we use is particularly apt for competitive market settings and therefore serves as a benchmark for other settings, providing an efficiency measure for their possible underperformance. Such analysis enhances the quality of policy recommendations.

### 1.3 Building blocks of an economy

We can be still more explicit about the building blocks of an economy. To understand the fundamental ideas underlying the economists' view of the world, consider an economy with only two products, goods and services. (Of course, this narrow example can and will be expanded in the course of this book.) The goods and services are produced by means of capital and labor. Here capital refers to physical structures, such as buildings and machinery, while labor is the human input required to operate the capital.

The production function for goods  $P^G$  in the equation  $y_G = P^G(K_G, L_G)$  indicates the quantity of goods output that can be produced with input quantities of capital and labor employed in manufacturing. Similarly, we have the equation  $y_S = P^S(K_S, L_S)$  for services. In a private property economy, households own the means of production, capital, and labor. They formulate their demand functions according to their endowments and preferences. For simplicity, let us assume that all households have the same preferences and can be represented by a single household whose preferences for goods and services are summarized by a utility function  $U(x_G, x_S)$  that subjectively values the consumption levels of the goods and services produced. One well-known example of a utility function is  $U(x_G, x_S) = x_G \cdot x_S$ , which presumes that positive quantities of both goods and services are essential (in other words, a zero amount of either would imply zero utility). Thus, the building blocks of this simplified, imaginary economy are preferences (that is, the utility function  $U$ ), resources (that is, the total quantities of capital  $K$  and labor  $L$ ), and technology (that is, the production functions  $P^G$  and  $P^S$ ). Supply and demand functions can then be derived, and, in turn, will determine the prices and quantities that we may expect to emerge in any free market. In the economic system of the model, there are four markets: two factor markets – one for capital, another for labor – and two product markets – one for goods, another for services. Recall that a factor is an “ultimate input” – for example, any raw material, rather than an intermediate, “produced input,” such as electricity. Any change in economic outcomes must be due to a change in one or more of these fundamentals.

**Example 1.1** The prices of services rise relative to the prices of goods. Health care, education, and other services get ever more expensive (ten Raa and Schettkat, 2001). One important cause is technical progress in manufacturing, where less and less input is needed to produce the same level of output, since innovations that introduce new technologies and modes of production organization, such as outsourcing, spur productivity growth. Economic analysis shows that such productivity gains can yield higher prices for services – seemingly in contradiction to the intuition that productivity gains are always cost-saving. This is because the productivity gains in manufacturing drive costs lower in those industries. *In comparison*, then, services’ costs go up, since those industries do not benefit from such cost-saving productivity gains.

A consumer’s demand function tells us how much of a good or service she wants to buy, given its price. Roughly speaking, consumer demand goes down when the price of a good or service goes up. However, the quantity demanded by a consumer depends not only on the price of the good or service but also on the prices of other goods and services. There are two main reasons for this. First, if there are inexpensive substitutes, demand for a good or service will be weak. This was the bleak situation Microsoft’s Xbox faced in the market for game consoles, where the lower prices of Nintendo’s Wii and Sony’s PlayStation 3 dampened the demand for Xboxes. This effect may also work the other way. For example, the low prices of game consoles boost the demand for games. Thus, the “other” price has a negative impact if the other product is a substitute (like a competing console) but has a positive impact if it is a complement (like a game).

Another type of cross-price effect is more macroeconomic. If a consumer is considering buying a product when the prices of all other products are going up, he not only chooses the inexpensive product but must also restrict his other purchases simply because he becomes poorer (if he has a stable income). Thus, price increases depress total demand in an economy by reducing real purchasing power.

## 1.4 Elasticities

Economists group all these effects under the heading of elasticities. Using these, we can discuss the concept of demand for a good or service as a function of its own price, if we keep all other prices fixed. We denote the quantity demanded by  $D(p)$ , where  $p$  is the price and  $D$  the demand function, which is declining. It is important to distinguish between a function, such as  $D$ , and a value it may take, such as  $D(p)$ . Thus, the statement “demand goes down” could mean two different things. One

interpretation is that nothing changes at the consumer end: Households have the same level of demand for the good or service, but the good or service becomes more expensive – for example, due to a disruption in production. In this case, the demand function remains the same, but its value is reduced. Another interpretation is that the users of the good or service are no longer interested in it – perhaps their taste has changed and they assign less utility to it. In this case the demand function *has* changed.

Before we analyze elasticities formally, let us review some mathematical concepts that we will use extensively. The first is the *inverse* of a function. If the quantity demanded is

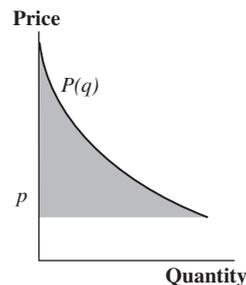
$$q = D(p) \quad (1.1)$$

we can solve equation (1.1) to get

$$p = P(q) = D^{-1}(q) \quad (1.2)$$

The inverse of a demand function  $D$ , function  $D^{-1}$  in equation (1.2), is called the *willingness-to-pay* function – also denoted by  $P$ . Figure 1.1 depicts an example that reveals the price at which a given quantity of goods or services will be purchased.

A simple example of a demand function is the *linear* function  $D(p) = \underline{q} - ap$ , where  $\underline{q}$  is the maximum quantity demanded (attained when the price is zero), and  $a$  is the slope of the demand function. If the price goes up by 1€, demand is reduced by  $a$  units (for example, liters of petrol) and the value of this function is reduced. If the maximum quantity demanded,  $\underline{q}$ , decreases, then the entire function changes, causing an inward shift. The graph of the function is a straight line with vertical intercept  $\underline{q}$  and horizontal intercept  $\underline{q}/a$ . Here,  $\underline{q}/a$  is the maximum price, at which demand becomes zero. If we solve the equation  $q = \underline{q} - ap$ , we obtain consumers' willingness to pay,  $p = (\underline{q} - q)/a = P(q)$ .



**Figure 1.1** The willingness-to-pay function.

Another example of a demand function is the *power* function  $D(p) = Ap^{-\alpha}$ , which has the advantage that it is defined for all positive prices. (In contrast, the linear demand function is defined only for prices below the maximum price  $p \leq q/a$ , otherwise the quantity demanded would be negative.) In the linear demand function, consumers' responsiveness to price is given by the slope  $a$ . For example, if  $a$  equals 2, then the demand for petrol is reduced by 2 liters if the price goes up by 1€. Formally,  $\frac{dD(p)}{dp} = -a$ , where the left-hand side denotes the *derivative* of the function  $D$ . It may also be denoted briefly by  $D'(p)$ .

In general, the derivative of a function measures the change in the dependent variable (in this case, the quantity demanded) per unit of change in the independent variable (that is, price) for small changes. It is defined by the following equation:

$$D'(p) = \frac{dD(p)}{dp} = \lim_{\Delta p \rightarrow 0} \frac{D(p + \Delta p) - D(p)}{\Delta p} \quad (1.3)$$

In equation (1.3) *lim* is short for *limit*, and the subscript  $\Delta p \rightarrow 0$  means that the price change,  $\Delta p$ , is small – in fact, going toward zero. Thus, it is easy to see that the derivative of the sum of two functions is the sum of the derivatives of the two functions. This observation is useful when collecting individual demands to calculate overall market demand. In a linear demand function, the size of the price change is immaterial because the quotient equals the slope,  $-a$ , as equation (1.4) shows:

$$\begin{aligned} \frac{dD(p)}{dp} &= \lim_{\Delta p \rightarrow 0} \frac{D(p + \Delta p) - D(p)}{\Delta p} = \lim_{\Delta p \rightarrow 0} \frac{q - a(p + \Delta p) - (q - ap)}{\Delta p} \\ &= \lim_{\Delta p \rightarrow 0} \frac{-a\Delta p}{\Delta p} = -a \end{aligned} \quad (1.4)$$

However, measuring the responsiveness of demand by the reduction in liters per euro price increases is problematic. First, this measure of the responsiveness of demand depends on the choice of units. If we were to measure petrol in gallons – as Americans do – rather than the much smaller liter, this measure of the responsiveness of demand would shoot down. Similarly, if we use a weaker currency, like the American dollar, this measure of the responsiveness of demand would also be reduced. This is because the reduction in demand in response to a price increase of one US penny is smaller than that in response to an increase by one eurocent. Second, the relationship between demand and price depends on the unit of time. If we are talking about changes in weekly demand, then fluctuation in demand of two liters per week seems reasonable. However, if we are talking about changes in daily demand, this response would be quite strong.

Measuring such changes as percentages avoids such ambiguities. The *elasticity* of demand measures the *percentage* change in quantity per *percentage* change in price. It is defined by the following expression:

$$\varepsilon^D(p) = \frac{dD(p)/D(p)}{dp/p} \quad (1.5)$$

In this expression we use only proportionate changes, since the percentage conversion factors of 100 cancel out in the numerator and denominator. For example, if a price increase from 2 euros per liter to 2.01 euros per liter yields a demand reduction from 10 to 9.8 liters, then the elasticity expression (1.5) becomes  $\frac{-0.2/10}{0.01/2} = -20 \left(\frac{2}{10}\right) = -4$ . This means that a 1 percent price increase leads to a 4 percent reduction in the quantity demanded.

While linear functions have constant derivatives, power functions have constant elasticities. To appreciate this mathematical fact, we must first take the derivative of a power function:

$$\frac{dAp^{-\alpha}}{dp} = -\alpha Ap^{-\alpha-1} \quad (1.6)$$

Rule (1.6) shows that the derivative of a power function is obtained by multiplying the function with the power and then lowering the power in the exponent by one. This rule is a consequence of the definition of the derivative of a function, given in formula (1.3). Next we illustrate rule (1.6) for  $\alpha = 2$ :

$$\begin{aligned} \frac{dD(p)}{dp} &= \lim_{\Delta p \rightarrow 0} \frac{D(p + \Delta p) - D(p)}{\Delta p} = \lim_{\Delta p \rightarrow 0} \frac{A(p + \Delta p)^{-2} - Ap^{-2}}{\Delta p} \\ &= \lim_{\Delta p \rightarrow 0} A \frac{1/(p + \Delta p)^2 - 1/p^2}{\Delta p} = \lim_{\Delta p \rightarrow 0} \frac{A}{\Delta p} \frac{p^2 - (p + \Delta p)^2}{p^2(p + \Delta p)^2} \\ &= \lim_{\Delta p \rightarrow 0} \frac{A}{\Delta p} \frac{-2p\Delta p - (\Delta p)^2}{p^2(p + \Delta p)^2} = \lim_{\Delta p \rightarrow 0} A \frac{-2p - \Delta p}{p^2(p + \Delta p)^2} \\ &= A \frac{-2p}{p^2 p^2} = -2Ap^{-3} \end{aligned} \quad (1.7)$$

Substituting the result of (1.7) into (1.5) reduces the latter expression for the power function  $D$ , defined by  $D(p) = Ap^{-\alpha}$ , to simply:

$$\varepsilon^D(p) = \frac{dD(p)/D(p)}{dp/p} = \frac{dD(p)}{dp} \frac{p}{D(p)} = -\alpha Ap^{-\alpha-1} \frac{p}{Ap^{-\alpha}} = -\alpha \quad (1.8)$$

**Review exercise** Show that a linear demand function – for example,  $D(p) = 1 - p$  – has a variable elasticity.

As for linear functions, the coefficients signify the slope or derivative of the function, while (1.8) shows that for power functions the power signifies the elasticity. Since power functions  $D(p) = Ap^{-\alpha}$  feature elasticity  $\alpha$  at all prices, they are also called *constant elasticity* functions. For such functions, a price increase of 1 percent prompts a quantity decrease of  $\alpha$  percent. The greater the elasticity (in absolute value), the more sensitive demand is to price changes. If  $\alpha$  is greater than 1 (unity), demand is called *elastic*. If  $\alpha$  is less than unity, demand is called *inelastic* because the percentage change in quantity is smaller in magnitude than the percentage change in price. The borderline case,  $D(p) = Ap^{-1}$ , is called *unitary elastic*. In such a case, which forms the “border” between elastic and inelastic demands, a 1 percent increase in price prompts a 1 percent reduction in demand.

It is easy to show that for elastic demand a price increase reduces revenue. Revenue is the product of price and quantity, hence  $pAp^{-\alpha} = Ap^{1-\alpha}$  for constant elasticity demand functions. Indeed, revenue is a decreasing function if the exponent is negative,  $1 - \alpha < 0$  or  $\alpha > 1$ , as it is when demand is elastic. If  $\alpha < 1$  (inelastic demand), revenue is increasing. Therefore when demand is inelastic, a price increase raises revenue. These results remain valid for demand functions with varying elasticities.

**Review exercise** Determine the price range where demand  $D(p) = 1 - p$  is elastic.

If the demand for a product is elastic, price changes induce relatively large changes in the quantity demanded by consumers. This fact has many important implications. For one, in such industries, firms have less market power. If they want to raise price above cost, they erode their own market. When consumers respond strongly to a price increase, firms think twice before doing so. For another, we will see that goods with low elasticities are the best candidates for taxes, since they will impact little on the quantity and, therefore, minimize the distortion of the economy. Land is the classic example because its quantity is essentially fixed. Indeed, Henry George (1966) has argued that land rent should be the *sole* source of government funding.

With their universal units of measurement, elasticities are practical and important in assessing the impact of price changes due to taxation or market power. In principle they may vary from point to point, since linear demand functions have a constant slope but a varying elasticity. However, many applied economic models avoid this complication by working with functions that feature a constant elasticity. We use such functions to illustrate the analysis throughout this book.

## 1.5 Positive and normative economics

It is crucial to distinguish between economic policy questions about what *should* happen and explanations of what *actually* does happen. Let us first discuss the latter. Given the fundamentals of an economy – preferences, resources, and technology – we will explain how resources are allocated among productive activities and who gets the fruits of these labors. Our explanation will cover the pricing of resources and products, the quantities transacted, and the levels of well-being achieved. Roughly speaking, people who are well endowed with resources that are critical to the production of desired goods and services will be well off. In this way, market economies reinforce inequities.

The branch of economic analysis that examines these issues is called *positive* economics. Its main tool is equilibrium analysis; as the word suggests, “equilibrium” corresponds to a state of rest, where there are no forces to instigate a change from the current position. By using equilibrium analysis in microeconomics, we will find the prices at which supply equals demand. Of course, an exogenous shock to the system – that is, a market or set of markets – will change the equilibrium. Microeconomic analysis includes studying the directions and magnitudes of changes in the outcome – that is, endogenous variables – in response to changes in exogenous variables. This type of analysis, called “comparative statics,” compares the properties of different equilibria without necessarily revealing anything about the process of adjustment from one equilibrium to another. For instance, after a shock to the economy there will be a new equilibrium, but we cannot say if the economy adjusts to this by dipping once, twice, or not at all (at least not right away).

In principle, positive economics is neutral about assessing the quantities produced and consumed in equilibrium. Equilibrium may seem like a desirable state of affairs (after all, who would object to a demand for labor that meets supply – that is, full employment?). However, this is not necessarily the case. For example, if a firm has market power, as Microsoft does in desktop computer operating systems, the price of its product may be well above cost, and many potential customers who cannot afford the price but would be willing to pay the production cost are not served. These potential customers do not contribute to market demand. Thus, there is equilibrium between supply and demand at the higher price, but there is also latent demand that is not satisfied, but that could be met if the cost were covered. This is a hidden form of inefficiency.

The other branch of economics that studies what should be done in an economy is aptly called *normative* economics. There are two related sub-branches of normative economics. One investigates the inefficiency of a given allocation of resources across industries and of each industry’s products among end users. The reasoning that led us to conclude that there is inefficiency in the market for computer operating systems is an example of the application of this branch of economics. In this case, the outcome used to evaluate efficiency is determined

through the working of markets, with prices playing a role in allocation – that is, the number of computers purchased by consumers.

The other sub-branch of normative economics maps all the possible efficient allocations for an entire economy. It is important to understand that this does not require prices but, rather, involves mapping all the possible allocations of physical resources and products and then evaluating them on the basis of consumers' preferences. The range of such allocations is huge. For example, one allocation would put the bulk of one country's products in the hands of its president, though all products could just as well be in the hands of any other citizen. Prices may play a role in such allocations, but it is an indirect role. More precisely, we will investigate if any of these efficient allocations can be brought about by the market mechanism after a suitable redistribution of the resources.

Granted, there are “free-market economists” who equate equilibrium outcomes with efficient allocations. This is not a matter of dogma but depends on conditions that must be fulfilled, such as the absence of market power and external effects, like pollution. Microeconomics details the conditions under which equilibrium outcomes are efficient, and alternative efficient outcomes can be generated by the market mechanism. These results alert us to situations where these conditions are *not* fulfilled and aid us in designing policies that remedy the inefficiencies. One such policy is the relatively high taxation of items whose supply or demand is inelastic. In Chapter 2 we will analyze a simple economy without distortions caused by market power and external effects (that is, externalities). In other words, the close connection between equilibrium and efficiency holds for the simple economy presented in Chapter 2. The truth of this link will be ascertained only in later chapters, but we will make use of it right away to determine equilibrium prices by analyzing a simple efficiency problem.

## 1.6 Mathematical tools

In applying economic reasoning, the use of mathematical tools permits precision in defining concepts such as equilibrium and efficiency. Mathematics also helps us to make precise comparisons of different equilibrium outcomes. In addition to accurately determining the direction of changes in equilibrium outcomes, mathematical modeling allows us to quantify such effects. Ultimately, economic decision-makers – whether in households, firms, or governments – need quantitative estimates. For instance, estimates enable a household to plan a reallocation of spending in response to a price increase in petrol. Such estimates also help a firm decide how much to increase the price it charges consumers when its costs go up, or help a government to decide what tax rates to set for various goods and services.

Functions with a constant elasticity, such as the demand function  $q = D(p) = Ap^{-\alpha}$ , are especially amenable for estimation and therefore are commonly employed in economic modeling. This is because  $q = Ap^{-\alpha}$  is *log-linear*; if we take the natural logarithm we transform it into the following linear

relationship  $\ln q = \ln(Ap^{-\alpha}) = \ln A - \alpha \ln p$ . Consequently, elasticity is the slope of the regression line between the log of the quantity and the log of the price. This simple observation, which is easily extendable to multi-product markets, production, and other functions, explains why elasticities are frequently estimated in economics. Of course not all demand functions have constant elasticity, and in these cases a more complex function must be hypothesized. For example, such a demand function might be  $\ln q = \ln A - \alpha \ln p + \beta (\ln p)^2$ . Other functional forms are also possible. The key idea is that parameters, such as elasticities, allow us to test a particular mathematical hypothesis about the functional form against actual data. The resulting estimated parameters can subsequently be used in practical decision-making.

Before closing this chapter, three useful mathematical tools – the product rule, the quotient rule, and the chain rule – and the inverse operation of differentiation must be presented. The product rule applies to the product of two functions of a common variable. For example, if a firm sets price  $p$ , meets demand  $D(p)$ , and obtains a net price (excluding taxes)  $N(p)$ , then revenue is  $N(p)D(p)$ . How sensitive is revenue to price? In other words, what is the derivative of this product function? According to the *product rule*, it is the product of the derivative of the first function and the second function, plus the opposite product:

$$N(p)D(p) \text{ has derivative } N'(p)D(p) + N(p)D'(p) \quad (1.9)$$

The product rule given in (1.9) is a direct consequence of the fact that the derivative of  $N(p)D(p)$  can be rewritten as (1.10):

$$\begin{aligned} \lim_{\Delta p \rightarrow 0} \frac{N(p + \Delta p)D(p + \Delta p) - N(p)D(p)}{\Delta p} \\ = \lim_{\Delta p \rightarrow 0} \left[ \frac{N(p + \Delta p) - N(p)}{\Delta p} D(p + \Delta p) + N(p) \frac{D(p + \Delta p) - D(p)}{\Delta p} \right] \end{aligned} \quad (1.10)$$

The *quotient rule* has a slightly more complicated reading:

$$N(p)/D(p) \text{ has derivative } \frac{N'(p)D(p) - N(p)D'(p)}{D(p)^2} \quad (1.11)$$

The proof of rule (1.11) is as easy as that of the product rule:

$$\begin{aligned} \lim_{\Delta p \rightarrow 0} \frac{N(p + \Delta p)/D(p + \Delta p) - N(p)/D(p)}{\Delta p} \\ = \lim_{\Delta p \rightarrow 0} \frac{[N(p + \Delta p) - N(p)]D(p) - N(p)[D(p + \Delta p) - D(p)]}{\Delta p D(p)D(p + \Delta p)} \end{aligned} \quad (1.12)$$

The *chain rule* is relevant whenever two functions are composed. For example, let a firm set price  $p$ , meet demand  $q = D(p)$ , and incur cost  $C(q)$ . It follows that cost is eventually a function of price, which is given by the composite function  $C(D(p))$ . How sensitive is cost to price? In other words, what is the derivative of this composite function? According to the chain rule, this is the product of the derivatives:

$$C[D(p)] \text{ has derivative } C'[D(p)]D'(p) \quad (1.13)$$

The proof of the chain rule (1.13) is straightforward. The derivative of  $C[D(p)]$  is:

$$\begin{aligned} \lim_{\Delta p \rightarrow 0} \frac{C[D(p + \Delta p)] - C[D(p)]}{\Delta p} &= \\ \lim_{\Delta p \rightarrow 0} \frac{C[D(p + \Delta p)] - C[D(p)]}{D(p + \Delta p) - D(p)} \cdot \frac{D(p + \Delta p) - D(p)}{\Delta p} & \quad (1.14) \end{aligned}$$

If we substitute  $q = D(p)$  and  $\Delta q = D(p + \Delta p) - D(p)$ , then the first factor on the right-hand side of equation (1.14) reads  $\frac{C(q + \Delta q) - C(q)}{\Delta q}$ . Since  $\Delta q$  tends toward zero, as  $\Delta p \rightarrow 0$ , the proof of the chain rule is complete.

Typically, the quantity  $q$  is large, and therefore  $\Delta q = 1$  is small – that is, relatively close to zero. This explains why the derivative of cost,  $\frac{C(q + \Delta q) - C(q)}{\Delta q}$  ( $\Delta q \rightarrow 0$ ), is closely approximated by  $C(q + 1) - C(q)$ , the so-called *marginal cost* of the last unit. This explains why economists write *MC* instead of  $C'$ .

One simple, but practical, application of the chain rule is that  $dD(\underline{p} - p)/dp = -D'(\underline{p} - p)$ , where  $\underline{p}$  is a large given price (otherwise  $\underline{p} - p$  would be negative and  $D(\underline{p} - p)$  undefined). The composite function consists of the linear function  $\underline{p} - p$  and function  $D$ . The derivative of this linear function is  $-1$ , which explains the minus sign.

The second application is the rule for the derivative of an inverse. For instance, the inverse of the demand function given in equation (1.2) has the following derivative:

$$D^{-1}(q) \text{ has derivative } 1/D'(p) \quad (1.15)$$

Rule (1.15) states that the derivative of the inverse is the reciprocal of the derivative. The proof is simple. If we apply the inverse function (that is, the willingness-to-pay function) to the quantity  $q = D(p)$ , we obtain price  $p$ :  $D^{-1}[D(p)] = p$ . If we apply the chain rule to the left-hand side of the function, differentiation yields  $(D^{-1})'[D(p)] \cdot D'(p) = 1$ , while division yields  $(D^{-1})'(q) = 1/D'(p)$ .

The inverse operation of differentiation is integration. We define the concept of an integral by means of an area and then relate it to differentiation. Figure 1.1

reveals an interesting economic phenomenon – namely, that for the initial units of a good consumers’ willingness to pay exceeds the price. (Think of how valuable the first liters of petrol you put in your car’s tank are to you.) Consumers thus benefit from the law of one price. They buy up to the point where their willingness to pay equals the price. But since that same price also applies to all the other units bought, consumers pay less than their willingness to pay for those units. The difference between the two, called *consumer surplus*, is measured by the shaded area in Figure 1.1. The area under a nonnegative function  $D$  between lower bound  $a$  and upper bound  $b$  is called the *integral* of  $D$  between  $a$  and  $b$  and is denoted by  $\int_a^b D(p)dp$ , where the symbol  $\int$  stands for the integral. Consumer surplus is given by  $\int_p^\infty D(p')dp'$ , where  $\infty$  is infinity. If we differentiate the integral of  $D$  with respect to the upper bound, applying the definition (1.3), we obtain the function we integrated:

$$\begin{aligned} \frac{d}{db} \int_a^b D(p)dp &= \lim_{\Delta b \rightarrow 0} \frac{\int_a^{b+\Delta b} D(p)dp - \int_a^b D(p)dp}{\Delta b} = \lim_{\Delta b \rightarrow 0} \frac{\int_b^{b+\Delta b} D(p)dp}{\Delta b} \\ &= \lim_{\Delta b \rightarrow 0} \frac{D(b)\Delta b}{\Delta b} = D(b) \end{aligned} \tag{1.16}$$

Result (1.16) confirms that integration is differentiation in reverse and, moreover, is the key to the calculation of areas. (Similarly, differentiation with respect to the lower bound yields  $-D(a)$ .) For example, if the function is a power function,  $D(b) = b^{-\alpha}$ , it is the derivative of  $b^{1-\alpha}/(1-\alpha) + c$  ( $c$  is any constant), as is confirmed by subjecting the latter to formula (1.6). This is the so-called *primitive* function of  $D(b) = b^{-\alpha}$ , denoted  $\int D$ . This gives us  $\frac{d}{db} \left( \frac{b^{1-\alpha}}{1-\alpha} + c \right) = D(b)$ . Comparison of this with equation (1.16) shows that the area is  $\int_a^b D(p)dp = \frac{b^{1-\alpha}}{1-\alpha} + c$ . Since the constant is determined by substituting  $b = a$ , the area between  $a$  and  $b = a$  must be zero, hence  $c = -\frac{a^{1-\alpha}}{1-\alpha}$ . It follows that  $\int_a^b D(p)dp = \frac{b^{1-\alpha}}{1-\alpha} - \frac{a^{1-\alpha}}{1-\alpha}$ .

The procedure can be summarized as follows. To find the area under a nonnegative function  $D$  between a lower and upper bound, find the primitive, evaluate it in the upper and lower bounds, and subtract the evaluation of the lower bound from that of the upper bound.

Since integration is differentiation in reverse, the integral inherits several properties from the derivative. For example, the integral of the sum of two functions must be the sum of the integrals. Thus the product rule (1.9) also has a

counterpart. Since the derivative of  $N(p)D(p)$  is  $N'(p)D(p) + N(p)D'(p)$ , we have  $N(p)D(p) = \int [N'(p)D(p) + N(p)D'(p)] dp$ . Hence, the integral of  $N'(p)D(p) + N(p)D'(p)$  between  $a$  and  $b$  is  $N(b)D(b) - N(a)D(a)$  or, rearranging one term,

$$\int_a^b N'(p)D(p) dp = - \int_a^b N(p)D'(p) dp + N(b)D(b) - N(a)D(a) \quad (1.17)$$

Formula (1.17) is called *integration by parts*. When  $N(p)D'(p)$  is easier to integrate than a given  $N'(p)D(p)$ , this is a practical rule. When integrating the product of two factors, first try to find the primitive of one factor, then differentiate the other, and see if it simplifies.

## 1.7 Summary

The building blocks, or fundamentals, of an economy are consumer preferences (represented by utility functions), resources (that is, capital and labor), and technology (represented by production functions). In a private property economy, households own the resources and formulate their demand functions by maximizing utility, although they are subject to what their resources can buy. Their demands for goods and services depend on prices. Elasticities measure how changes in price affect demand. Producers use supply functions to identify which items are most profitable to produce. Supplies of goods and services also depend on prices. Positive economics seeks to explain the prevailing prices and the quantities bought and sold, as well as how sensitive these outcomes are to changes in the fundamentals of an economy. Normative economics detects inefficiencies – that is, demands that could be met but are not – and maps all possible efficient allocations of goods and services.

In addition to the concept of elasticity, this chapter discussed other useful tools – namely, the inverse function (that is, the willingness-to-pay function, if the underlying function is a demand function), differentiation (including the product rule, the quotient rule, and the chain rule), and the inverse operation of differentiation, integration (including integration by parts).

We are now equipped to analyze an economy, and that is just what we will do in the next chapter – albeit for a simple economy that involves only capital, labor, one good, and one service.

## Exercises

1. Are the following statements examples of positive or normative economics?
  - a. In an economic crisis real wages (that is, wages adjusted for the cost of living) are low.

- b. If students pay for their education, less teachers' time is wasted.
  - c. Perfectly competitive economies perform better than autocratic ones.
  - d. Free-market economies generate inequality.
2. Consider a constant elasticity demand function  $q = D(p) = Ap^{-\varepsilon}$  with elastic demand and a linear cost function  $C(q) = cq$ . Show price  $p = c\varepsilon/(\varepsilon - 1)$  maximizes the difference between revenue and cost – that is, profit.
  3. Which commodity has more elastic demand – housing or books? Why?
  4. Show the price in exercise 2 is a decreasing function of elasticity and explain this phenomenon.
  5. Show the consumer surplus of a constant elasticity demand function with elastic demand is  $Ap^{1-\varepsilon}/(\varepsilon - 1)$ .

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## Index

- access fees 321
- acidification 265
- adverse selection 311
- advertising 285
- Afriat's Theorem 47
- aggregation 98–100
- Aggregation Theorem 126
- airlines 5, 283
- allocation 192–193
- allocative efficiency/inefficiency 13–14, 201–202, 216–217
- altitude isoquants 30, 31
- analytical method for equilibrium 163–164
- Arrow–Pratt coefficient of absolute risk aversion 305–307
- Arrow–Pratt coefficient of relative risk aversion 307, 313
- Asano, S. 257
- average cost 130–131, 152, 233, 234
- average product 131, 145–146
- Badinger, H. 154–155
- Bailey, E. 231
- Bain, J. 283
- Baker, P. 323
- banking industry 242
- basic necessities 45
- Basu, S. 131
- Baumol, W. 231
- Baye, M. 318
- benchmarks, efficiency 191–192, 235–239
- Bernoulli function 297–299, 302–303
  - risk analysis 304–307
- Bertrand games 277–280
- best responses 276–277, 279–280, 280–281, 286, 288
- better allocations 198–200
- bimatrix games 284–293
  - constant-sum games 288–293
  - Nash equilibrium 284–286, 287–288, 288–289, 290–291, 292
  - randomized strategies 286–287, 292
- Blundell, R. 323
- bonuses 311–312
- Bourguignon, F. 256
- Bresnahan, T. 276
- Brouwer's Theorem 172–173, 287
- Browning, M. 256
- budget constraints 43–44
  - equilibrium analysis 160, 165–167
- Burdett, K. 318, 319
- Burnside, C. 131
- business services 109
- Canada 217–218, 256
  - Ramsey taxes 256–257
- capacity 124
- capital 4, 7, 22–23, 80, 106, 140
  - heterogeneity 196
  - optimization of the economy 25–29
  - production analysis 106–107, 112–113, 123–125
- chain rule 16
- Cherchye, L. 256
- Chiappori, P.-A. 256
- China 64, 324
  - measurement of inequality in 269–270
- Cirera, X. 64
- club goods 248, 249, 258–260
- Coase Theorem 261
- Cobb–Douglas production function 36, 122–123, 129, 151
  - derivation 124–126, 133–134
  - supply and demand 138–141
- Cobb–Douglas utility function 43, 50, 51–52, 53
  - demand function 49
  - income and substitution effects 65–66
  - price index 56–57
  - searching 316–317
- coefficient of price variation 318
- commodities (produced inputs) 106, 126–128
  - see also* goods; services
- commodity bundle 296, 299
- commodity set 295–296, 299
- commodity taxation 256–257
- common property resources 248, 249, 260–262
- comparative advantage 209, 220
- comparative statics 13
- compensated (Hicksian) demand 66–74
- compensating variation 86–90, 93
- compensation schemes 311–312
- competition
  - game theory 276–284
  - new industrial organization 281–284
  - perfect 137–138, 153–154, 191–192
  - price 276–280
  - quantity 276–277, 280–281
- competition policy 207, 324
  - and market power 207, 225–245
- complementary slackness, phenomenon of 33, 34, 145, 220, 238–239
- complements 65
- complete markets 192
- compound lotteries 299–300
- conduct parameter 282–284
- consistent conjectural variations 276–277
- constant elasticity functions 12, 14–15

- constant elasticity of substitution (CES) utility functions 45, 50–53, 54, 55, 210  
 consumer surplus for 93–96  
 demand function 69–70  
*see also* Cobb–Douglas utility function; Leontief utility function
- Constant Returns Proposition 146–147
- constant returns to scale 260  
 production functions 128–129, 131  
 theory of supply 140–141, 144–145, 146–147, 148
- constant-sum games 288–293
- constrained optimization 21, 29–36, 44–45, 172  
 application of Lagrangean theory to the economy 34–36
- constraints 21, 22–23
- consumer demand *see* demand
- consumer preferences *see* preferences
- consumer price index 59, 61
- consumer sovereignty 85
- consumer surplus 17, 85–86, 89–100  
 CES demand 93–96  
 income changes 96–98  
 performance measurement 220–223
- consumer well-being 85–101  
 aggregation 98–100  
 CES demand 93–96  
 exact measures of price changes 86–89  
 income changes 96–98  
 quasi-linear demand 92–93  
*see also* consumer surplus; standard of living
- consumers 4, 6, 41–42, 110
- consumption 41, 141  
 final and intermediate 106  
 intertemporal (savings) 77–80  
 tracking to measure performance 209, 210–213  
 uncertain 296–297, 299
- Consumption Tracking Proposition 211–212
- contestability 227
- contingencies analysis 307–310
- continuous differentiability 171, 174
- contours 30, 31
- contract curve 167–170, 193
- coordination 4
- cost–benefit analysis 315–320, 326
- cost function 150–151
- cost minimization 123, 138–139, 149–152, 226–227
- costs  
 average cost 130–131, 152, 233, 234  
 cost of information 322  
 incremental 228  
 marginal cost 152  
 search 315–320  
 short-run 151–152  
 stand-alone 228  
 switching 331–325  
 transaction 320–321
- Cournot games 277, 280–281
- cumulative probability density function (probability distribution) 316–321
- data-envelopment analysis 234–242
- Davenport, W. 291–293, 304
- De Haan, M. 265
- De Rock, B. 256
- dead-weight loss 222
- decreasing returns to scale  
 equilibrium 180–181  
 production functions 129–130, 131  
 theory of supply 139–140, 143, 145, 146, 147, 148
- degenerate lotteries 299
- demand 8, 63–83  
 compensated 66–74  
 consumer surplus and CES demand 93–96  
 elasticity of 11–12, 65  
 excess 157, 159, 163–164  
 and expenditure 48–50, 69–71  
 final and intermediate 63  
 independent demands 229–230  
 inelastic 12, 256–257  
 intertemporal consumption 77–80  
 latent 13
- Law of Demand *see* Law of Demand
- for leisure time 80–82
- market demand *see* market demand
- ordinary (Marshallian) 68, 71–74  
 and price 8–12, 63, 64–66, 71–74  
 production costs and input demand 149–152  
 quasi-linear 92–93  
 Roy's Lemma 76–77  
 and supply 138–141, 159
- demand functions 7, 8–12, 14–15, 41, 49
- derivative of a function (slope) 10, 11–12
- derivatives 310
- differentiation 10–12, 15–16
- direct (ordinary) utility 58
- directly revealed preferences 45–46
- discount factor 77–78, 315–316, 319  
 subjective 79
- distribution  
 income 210, 266–270  
 inefficiency in 201–202
- disutility of risk 304–305
- Domar ratio 217
- Donni, O. 255
- duopoly 226, 283
- dynamic efficiency 213–218
- economic fundamentals 6, 7–8, 159
- economic policy 4
- Edgeworth box 164–167
- effective number of firms 282
- efficiency 5, 13–14, 159, 191–206  
 analyzing dynamic efficiency 213–218  
 analyzing static efficiency 218–220  
 and equity 269–270  
 First Welfare Theorem 5, 21, 191, 192–194, 196, 232, 279  
 industry efficiency and supportable prices 243  
 inefficiency *see* inefficiency  
 measuring for a firm 234–239

- measuring for an industrial organization 240–242
- Second Welfare Theorem 5, 191, 194–196, 203–204, 252
- elastic demand 12
- elasticities 8–12
  - elasticity of demand 11–12, 65
  - elasticity of substitution 50, 51, 54
- electricity 4–5
  - electric utilities ownership and efficiency 239
  - switching between suppliers 323–324
- emission rights 261–262, 264
- endogenous variables 6
- endowments 159, 160–161
  - analyzing dynamic efficiency 213–218
- Edgeworth box 164, 165
- energy suppliers, switching between 323–324
- Engel curves 63, 64, 73
- entry deterrence 225–234, 275
- Envelope Theorem 68–69, 70–71
- environmental economics 4, 262–265
- equilibrium 13, 157–158, 159–189, 191
  - alternative utility and production functions 180–181
  - analysis for exchange economies 170–176, 183–186
  - analysis for production economies 176–179, 186–188
  - analytical approach 163–164
  - contract curve 167–168
  - First Welfare Theorem 193–194
  - general equilibrium analysis 170–181, 183–188
  - graphical method 164–167
  - homogeneity 161
  - Negishi’s method 158, 160, 168–170
  - quasi-equilibrium 185–186
  - Second Welfare Theorem 194–196
  - Walras’ Law 161–163, 163
- Equilibrium Existence Theorem 194–195, 196
  - exchange economies 172–176, 183–186
  - production economies 179, 186–188
- equity 196
  - measuring inequality 265–270
- equivalent variation 86–90, 93
- Euler’s Theorem 129
- euro 162
- European Union (EU) 4
  - Lerner index for different industries 154–155
- eutrophication 265
- exact price index 59–61
- excess demand 157, 159, 163–164
- excess income 174–176
- excess supply 159, 164
- exchange economies 159–60
  - Equilibrium Existence Theorem 172–176, 183–186
  - general equilibrium analysis 170–176, 183–186
  - simple exchange economy and equilibrium 159–160, 160–170
- excludable goods 247, 248–249
- exogenous variables 6
- expansion factor 235–236, 237
  - industry’s 241–2
- expected utility 299–304, 306
- searching 316–317, 326
- expenditure
  - demand and 48–50, 69–71
  - minimization 50
- expenditure functions 53–58, 85
- exports 204
- externalities 192, 260–262
  - environmental economics 262–265
- factor input coefficients 107
- factor inputs 106
- factor markets 7
- factor productivity ratio 28–29
- Fageda, X. 283
- Färe, R. 239
- feasible allocations 192–193
- feasible region 30–32
- Fedderke, J. 114–115
- female share of household resources 256
- Fernald, J. 131
- ferry services 91, 230–231
- Fershtman, C. 320
- final consumption 106
- final demand 63
  - see also* demand
- financial instruments 309–310
- firm-level efficiency 234–239
- First Constant-Sum Game Theorem 290
- first-order condition 32
- First Welfare Theorem 5, 21, 191, 192–194, 196, 232, 279
- fish stocks 260, 261
- Fisher price index 61
- fishermen, Jamaican 291–293, 304
- Fishman, A. 320
- fixed inputs 130
- fixed point 171, 172–173, 174, 176
- fixed wages 311–312
- food 64, 256–257, 265
- France 132
- free-market economists 14, 196
- free trade 4
- frontier production plans 176–178
- Fukushima, T. 257
- Functional Separability Theorem (sufficiency) 128, 134–135
- Functional Separation Theorem (necessity) 127
- fundamentals, economic 6, 7–8, 159
- Gale, D. 46–47
- game theory 275–294
  - best responses 276–277, 279–280, 280–281, 286, 288
  - bimatrix games 284–293
  - constant-sum games 288–293
  - Nash equilibrium *see* Nash equilibrium
  - new industrial organization 281–284
  - price games 276–280
  - quantity games 276–277, 280–281
  - randomized strategies 286–287, 292
  - strategies 276–277

- general equilibrium analysis  
   170–181, 183–188  
   alternative utility and production  
   functions 180–181  
   exchange economies 170–176,  
   183–186  
   production economies 176–179,  
   186–188  
 General Functional Separability  
   Theorem (sufficiency) 128  
 George, H. 12  
 Germany 132  
 Giffen goods 73–74  
 Gini Index 266–268  
 goods 4, 7, 111, 112–113  
 graphical method for equilibrium  
   164–167  
 Green, J. 194  
 gross output 106–107, 109–110,  
   111–112  
 Grosskopf, S. 239  
  
 Harberger, A. 222–223  
 Harberger's triangle 222  
 Härdle, W. 75  
 Harris, R. 256–257  
 head tax 265–266  
 Henry George Theorem 259–260  
 heterogeneity 196–197  
 Hicksian (compensated) demand  
   66–74  
 Hildenbrand, W. 75  
 Holmström, B. 311  
 homogeneity 161  
 homotheticity 78, 79  
 Honkapohja, S. 183  
 Hotelling's Lemma 149  
 households, allocations within  
   255–256  
 Houthakker, H. 126  
  
 imports 204  
 incentive compatibility constraint  
   312  
 income  
   changes and consumer surplus  
   96–98  
   compensation schemes 311–312  
   demand and 63–4, 210  
   and demand for food 64  
   earned by a firm 108–109  
   excess 174–176  
   and level of utility 48–50  
   national 109–110  
   uncertain 297–298, 301, 303,  
   311–312  
 income distribution 210, 266–270  
 income effects 65–66, 72–75,  
   81–82, 137, 262  
 increasing returns to scale 225  
   equilibrium 180–181  
   production functions 130, 131  
   theory of supply 143, 144, 146,  
   147  
 incremental costs 228  
 independence axiom 299–301, 302  
 independent demands 229–230  
 India 64  
 indifference curves 43–45,  
   164–168  
 indirect utility 58, 76  
 indirectly revealed preferences 47  
 industrial organization 275  
   efficiency 240–242  
   new 281–284  
   price setting and entry deterrence  
   225–234, 275  
 industry cost function 226–227  
 industry efficiency  
   measuring 240–242  
   and prices 243  
 inefficiency 191–192, 196–206  
   determination of 197–200  
   distinguishing from efficiency  
   196–197  
   measurement of 200–202  
   in small, open economies  
   202–205  
 inelastic demand 12, 256–257  
 inequality measures 265–270  
 information 273–274  
   cost of 322  
   incomplete *see* uncertainty  
   searching 315–320, 326  
   switching costs 321–325  
   value of 322, 323  
 Inklaar, R. 132  
 input–output analysis 110–118,  
   269–270  
   pollution 264–265  
   technical change 115–118  
   total factor productivity  
   113–115  
  
 input–output coefficients 105, 107,  
   107–108, 115–118, 124–126  
 input–output tables 106–107  
 inputs 105, 106–107  
   efficiency benchmarking for an  
   industry 235–239  
   fixed 130  
   produced 106, 126–128  
   production costs and input  
   demand 149–152  
 insurance 309, 310, 310–311  
 integration 16–18  
   by parts 18  
 interdependencies 4–5  
 interest rate, real 79  
 intermediate consumption 106  
 intermediate demand 63  
 intermediate input coefficients  
   107, 142  
 international prices 203–205  
 international trade 202–205  
   sources of inefficiency 209,  
   213–218  
 intertemporal consumption  
   (savings) 77–80  
 inventory investment 198  
 inverse demand function  
   (willingness-to-pay function)  
   9, 90  
 Inverse Elasticity rule 153–154,  
   256–258  
 inverse operation of differentiation  
   *see* integration  
 Ireland 74  
 isoquants 30–32, 134–135  
  
 jackpot lotteries 301–304  
 Jamaican fishermen 291–293,  
   304  
 Japan  
   banking industry 242  
   Ramsey taxes 257  
 Jerison, M. 75  
 joint production 142  
 Jorgensen, D. 196  
 Jørgensen, F. 91, 230–231  
 Judd, K. 318, 319  
  
 Keane, M. 82  
 Kee, P. 265

- labor 4, 7, 22–23, 106, 140  
 general equilibrium analysis 180  
 heterogeneity 197  
 optimization of the economy 25–29  
 production analysis 106–107, 112–113, 124–125  
 supply 80–82
- Lagrange multipliers 21, 32–34, 108  
 analyzing static efficiency 218–220  
 firm-level efficiency 237–239
- Lagrangian function 32–33, 68
- Lagrangian theory 32–34  
 application to the economy 34–36
- land 12, 258–259
- Larsen, B. 91
- Laspeyres price index 58–61
- latent demand 13
- Law of Demand 73–74, 148  
 for compensated functions 67  
 for markets 75
- Law of Supply 147–149
- Lechene, V. 256
- leisure time, demand for 80–82
- Leontief, W. 110, 128
- Leontief inverse 117
- Leontief production function 122, 123–124, 150
- Leontief utility function 43, 50, 51–52, 53, 185  
 demand function 49  
 price index 56
- Lerner index (relative mark-up) 154–155, 222–223, 230, 281, 282
- liberalization 324
- limit pricing 232–234
- Lindahl equilibrium 252, 253, 254
- Lindahl prices 252–256
- linear demand function 9, 10
- linear production function 151
- linear utility function 52, 53, 56, 301  
 quasi-linear utility functions 92–93, 99–100
- local public goods 258–259
- Logan, J. 239
- Lorenz curve 266–267
- lotteries 296–313
- luxury goods 45, 73
- MacKinnon, J. 256–257
- macroeconomics 3
- Manning, R. 315–316
- manufacturing 8
- marginal cost 152
- marginal cost pricing 221–222, 225, 229
- marginal product 131, 145–146  
 of capital 24, 36  
 of labor 24, 36
- marginal rate of capital transformation 27, 28, 35–36
- marginal rate of labor transformation 27, 28, 36
- marginal rate of substitution 25–27, 27–28, 36, 44–45, 51, 308  
 contract curve 168, 168–169
- Lindahl prices 252–256  
 between public goods and private goods 250–252  
 two-stage production and 126–128
- marginal rate of transformation 25, 27–28, 35–36, 187, 252
- marginal utility 24
- market demand 75, 248–249, 281–282  
 measuring consumer well-being 98–100
- market failure 248
- market form 226–227, 282–284
- market-makers 275
- market power 5, 152–155, 192, 207, 225–245  
 consumer surplus and 220–223  
 industry efficiency and prices 242
- Lerner index 154–155, 222–223, 230, 281, 282
- limit prices 232–234
- measuring efficiency of an industrial organization 240–242
- measuring firm-level efficiency 234–239
- new industrial organization 282–284
- post-liberalization 324
- Ramsey prices 229–232, 234
- supportable prices 228, 243
- sustainable prices 226–228, 231–232
- Weak Invisible Hand Theorem 231–232
- market pricing 324
- market structure 282–284
- markets 4, 7, 159  
 complete 192  
 incomplete 261  
 Law of Demand 75
- Marshallian (ordinary) demand 63–66, 67, 68, 71–74
- Mas-Colell, A. 194
- Masset, E. 64
- Mathisen, T. 91
- maximin strategies 289–291
- Maximin Theorem 290
- maximization of a function 23–25
- mergers of firms 226–227, 234, 240
- Micklewright, J. 323
- microeconomics 3–4
- Microsoft 8, 13, 153
- Milgrom, P. 311
- mixed strategies 286–287, 292
- Mohnen, P. 217–218
- monopoly 5, 152–153, 230, 283  
 natural 226
- monopsony 153
- moral hazard 311
- Morgan, J. 318
- Morgan, P. 315–316
- Morgenstern, O. 299
- Nash, J. 286, 287
- Nash equilibrium 278, 284–286, 287–288  
 Bertrand–Nash equilibrium 278, 279–280  
 constant-sum games 288–289, 290–291, 292  
 Cournot–Nash equilibrium 280–281
- Nash Equilibrium Theorem 287–288
- national defense 247
- national income 109–110
- national product 109–110
- natural monopoly 226
- Negishi, T. 158, 170
- Negishi's method 158, 160, 168–170

- net output 106–107, 109, 111–112  
net supply 143  
Netherlands, the 4, 132, 162, 226, 323–324  
pollution and globalization 265  
state lottery 299  
new industrial organization 281–284  
nonexcludable goods 247–248, 248–249  
non-normal goods 73–74, 89  
nonrivalrous goods 247, 248–249  
nonsatiation utility functions 194  
normal goods 73, 74, 89  
normalization of the price system 163, 219–220  
normative economics 13–14  
Norway ferry services 91, 230–231
- oligopoly 283  
opportunity cost 80  
optimization  
constrained *see* constrained optimization  
of the economy 25–29  
options 310  
ordinary (Marshallian) demand 63–66, 67, 68, 71–74  
outcomes 6  
outputs 105, 106–107  
efficiency benchmarking 235–239  
gross output 106–107, 109–110, 111–112  
net output 106–107, 109, 111–112  
potential *see* production functions  
*see also* input–output analysis; input–output coefficients  
overcharging 5, 137  
ownership of firms 239, 324
- Paasche price index 58–61  
Pan, H. 269–270  
Pareto distribution 124, 126, 133–134  
Pareto dominant allocations 193  
Pareto efficiency 193  
Second Welfare Theorem 194–196  
participation constraint 312  
pay-offs 276
- Pedersen, H. 230–231  
perfect competition 137–138, 153–154, 191–192  
performance measurement 207, 209–224  
analyzing dynamic efficiency 213–218  
analyzing static efficiency 218–220  
consumer surplus and market power 220–223  
tracking consumption 209, 210–213  
phenomenon of complementary slackness 33, 34, 145, 220, 238–239  
Phuoc, T. Le 242  
Pigovian taxes 263–264  
polluter pays principle 263  
pollution 4, 261–265  
emission rights 261–262, 264  
Pomp, M. 323–324  
positive economics 13  
potatoes 73–74  
potential output *see* production functions  
power demand function 10, 11–12  
preferences 6, 7, 21  
revealed 45–48  
*see also* utility; utility functions  
price 4–5, 6  
changes and consumer surplus 91–92, 95–96  
coefficient of price variation 318  
demand and 8–12, 63, 64–66, 71–74  
exact measures of price changes 86–89  
industry efficiency and prices 243  
international prices 203–205  
Lerner index 154–155, 222–223, 230, 281, 282  
limit prices 232–234  
Lindahl prices 252–256  
normalization 163, 219–220  
quantities, prices and the standard of living 53–55  
Ramsey prices 229–232, 234, 321  
reservation price 319–320
- rise of services prices relative to goods prices 8  
setting and entry deterrence 225–234, 275  
supply and 140–141, 147–149  
supportable prices 228, 243  
sustainable prices 226–228, 231–232  
price adjustment function 157  
price discrimination between consumers 201  
price elasticity of demand 11–12, 65  
price games 276–280  
price indices 55–61  
price ratio 44–45, 51, 187, 308  
primitive function 17  
Prisoner's Dilemma 284–285  
private goods 247, 248, 249, 255  
private ownership 239, 324  
privatization 324  
probability  
analyzing uncertainty 296–313  
cumulative probability density function 316–321  
produced inputs (commodities) 106, 126–128  
producer surplus 221–222  
producers 4, 6, 41–42, 110  
product  
average 131, 145–146  
heterogeneity 197  
marginal 24, 36, 131, 145–146  
product markets 7  
product rule 15  
production 41, 103, 105–119  
accounting for inputs and outputs 106–107  
analyzing dynamic efficiency 213–218  
input–output analysis 110–118  
joint production 142  
national income and national product 109–110  
productivity, profit and value-added 107–109  
sources of inefficiency 209, 213–218  
technical change 115–118  
total factor productivity 113–115, 116–118

- production economies  
determination of inefficiency 198–200  
equilibrium analysis 176–179, 186–188
- production efficiency 196–201  
efficiency gains 209, 213–218
- production functions 7, 22–23, 121–136  
Cobb–Douglas *see* Cobb–Douglas production function  
general equilibrium analysis 176–179, 180  
Leontief 122, 123–124, 150  
returns to scale 128–132  
two-stage production and marginal rates of substitution 126–128
- production possibility set 141–143, 146–147, 176–179
- productivity 105, 142–143  
analyzing dynamic efficiency 213–218  
growth and technical change 8, 115–118  
profit, value-added and 107–109  
total factor productivity 113–115, 116–118, 217–218
- profit 103, 139, 143, 148–149  
productivity, value-added and 107–109  
supernormal 223
- profit maximization 138, 138–141, 145–146, 149–152, 188  
under international prices 203–205
- property rights 261–262, 264
- public economics 207–208, 247–272  
club goods 248, 249, 258–260  
environmental economics 4, 262–265  
externalities 192, 260–262  
measuring inequality 265–270  
Ramsey taxes 256–258
- public goods 207–208, 247–248, 249, 249–252  
Lindahl prices 252–256  
local 258–259
- public ownership 239, 324
- pure strategies 286
- quantity  
price, demand and 8–12  
prices, quantities and the standard of living 53–55
- quantity games 276–277, 280–281
- quasi-concavity 171–172, 174, 175–176, 178, 183
- quasi-equilibrium 185–186
- quasi-linear utility functions 92–93, 99–100
- quotient rule 15
- Ramsey prices 229–232, 234, 321
- Ramsey Rule for optimal product pricing 230
- Ramsey Rule of Taxation 256
- Ramsey taxes 256–258
- randomized strategies 286–287, 292
- Rawlsian welfare function 98, 99, 266
- Read, C. 292–293
- Read, D. 292–293
- real rate of interest 79
- real wage 81–82
- relative mark-up (Lerner index) 154–155, 222–223, 230, 281, 282
- representative consumer 210–211
- Representative Consumer Proposition 211
- reservation price 319–320
- resources 6, 7, 13, 21, 106  
*see also* capital; labor
- retaliatory pricing 243
- returns to scale 176  
production functions 128–132  
theory of supply 143–147  
*see also* constant returns to scale; decreasing returns to scale; increasing returns to scale
- revealed preferences 45–48
- revenue 12, 108
- revenue/cost ratio 239
- risk  
analysis 304–307  
attitudes towards 270, 297–298, 304  
risk aversion 297–298, 304, 304–307  
risk neutrality 297–298, 304  
risk premium 304–305
- rivalrous goods 247, 248, 249
- roads 247–248
- Robinson Crusoe economy 180, 201–202
- robust strategies 289–291
- Roy's lemma 76–77
- Russia 194, 256  
*see also* Soviet Union
- safe assets 309–310
- sales tax 256
- Samuelson Rule 252, 253
- savings 77–80
- scale economies index 131, 146
- scarcity 21, 22
- Schettkat, R. 8
- Scholten, P. 318
- searching 315–320, 326
- second-best pricing rule 225, 230, 256
- Second Constant-Sum Game Theorem 290–291
- Second Welfare Theorem 5, 191, 194–196, 203–204, 252
- self-interest 278–279
- Semple, J. 183
- services 4, 7, 8, 111, 112–113
- shadow prices *see* Lagrange multipliers
- Shapiro, M. 60, 61
- Sharkey, W. 228
- Shephard's Lemma 69–71, 88
- Shestalova, V. 323–324
- Shorrocks, A. 268, 269
- short-run costs 151–152
- Singh, N. 308, 321
- slack 33, 34, 142, 145, 220, 238–239
- Slutsky equation 71–74
- small, open economies 202–205
- Solow, R. 115
- Solow residual 114, 117–118, 215–217, 218
- Solvoll, G. 230–231
- South Africa 114–115
- Soviet Union 194, 324  
*see also* Russia
- Spanish airlines 5, 283
- splitting of firms 234, 240
- stand-alone costs 228
- standard of living 41–42  
quantities, prices and 53–55  
*see also* consumer well-being

- static efficiency 218–220
- strategies 276–277
  - randomized 286–287, 292
- Strong Axiom of Revealed Preference 47–48
- strong returns to scale 147
- structure-conduct-performance paradigm 283–284
- subgroup consistency 268–269
- subjective discount factor 79
- substitutes 65
- substitution, elasticity of 50, 51, 54
- substitution effects 65–66, 72–75, 81–82
- supernormal profit 223
- supply 137–156
  - and demand 138–141, 159
  - excess 159, 164
  - Hotelling's Lemma 149
  - Law of Supply 147–149
  - market power 152–155
  - net 143
  - production costs and input demand 149–152
  - production possibility set 141–143
  - returns to scale 143–147
- supportable prices 228, 243
- surplus
  - consumer *see* consumer surplus
  - producer 221–222
  - total 221–222
- sustainable prices 226–228, 231–232
- switching costs 321–325
- taxes
  - head tax 265–266
  - Pigovian 263–264
  - Ramsey 256–258
- technical coefficients *see* input–output coefficients
- technique 107
- technology 6, 7, 107
  - heterogeneity 199–200
  - technical change, efficiency changes and performance measurement 209, 213–218
  - technological progress and productivity growth 8, 115–118
- Telser, L. 228
- ten Raa, T. 8, 170, 217–218, 269–270
- terms of trade 161, 203
  - performance measurement 209, 213–218
- Thatcher, M. 266
- Theil Index 268–269, 270
- time
  - demand for leisure time 80–82
  - preference 77, 79
- total factor productivity 113–115, 116–118
  - Canada 217–218
- total surplus 221–222
- trade, international *see* international trade
- transaction costs 320–321
- transparency 324
- two-stage production 126–128
- uncertainty 273–274, 295–314
  - contingencies analysis 307–310
  - expected utility theory 299–304, 306
  - fixed wages vs. bonuses 311–312
  - insurance 309, 310, 310–311
  - modeling 295–299
  - risk analysis 304–307
- undercutting 137–138, 227–228, 243
- unitary elastic demand 12
- United States of America (US) 64, 223, 239
  - returns to scale 131–132
- utilitarian welfare function 98–100, 266
- utility 41–62, 210
  - consumer surplus tracking 97–98
  - determination of inefficiency 198–200
  - direct 58
  - expected utility 299–304, 306, 316–317, 326
  - indirect 58, 76
  - marginal 24
  - price indices 55–61
  - quantities, prices and the standard of living 53–55
- utility frontier 99, 100
- utility functions 7, 39, 42–53, 85
  - CES functions *see* constant elasticity of substitution (CES) utility functions
  - demand and expenditure 48–50
  - First Welfare Theorem 193–194
  - general equilibrium analysis 170–176, 180
  - quasi-linear 92–93, 99–100
  - revealed preferences 45–48
  - see also* expenditure functions
  - utility maximization 21–29, 173–175, 184–185
  - application of Lagrangean theory 34–36
  - public goods 249–250
- value-added 107–109
- value of information 322, 323
- variables 6
- Varian, H. 48
- Vermeulen, F. 256
- von Neumann, J. 299
- von Neumann-Morgenstern (expected) utility 299–304, 306, 316–317, 326
- wages
  - fixed 311–312
  - real wage 81–82
  - see also* income
- Walras' Law 161–163, 163
- Walrasian equilibrium 162, 192
- Weak Axiom of Revealed Preference 46–47
- Weak Invisible Hand Theorem 231–232
- weak returns to scale 147
- welfare theorems 5, 191–192, 192–196
  - First 5, 21, 191, 192–194, 196, 232, 279
  - Second 5, 191, 194–196, 203–204, 252
- Whinston, M. 194
- Wilcox, D. 60, 61
- Willig, R. 231
- willingness-to-pay function 9, 90
- X-efficiency 216–217
- zero-sum games 288, 291–293
- Zlobec, S. 183