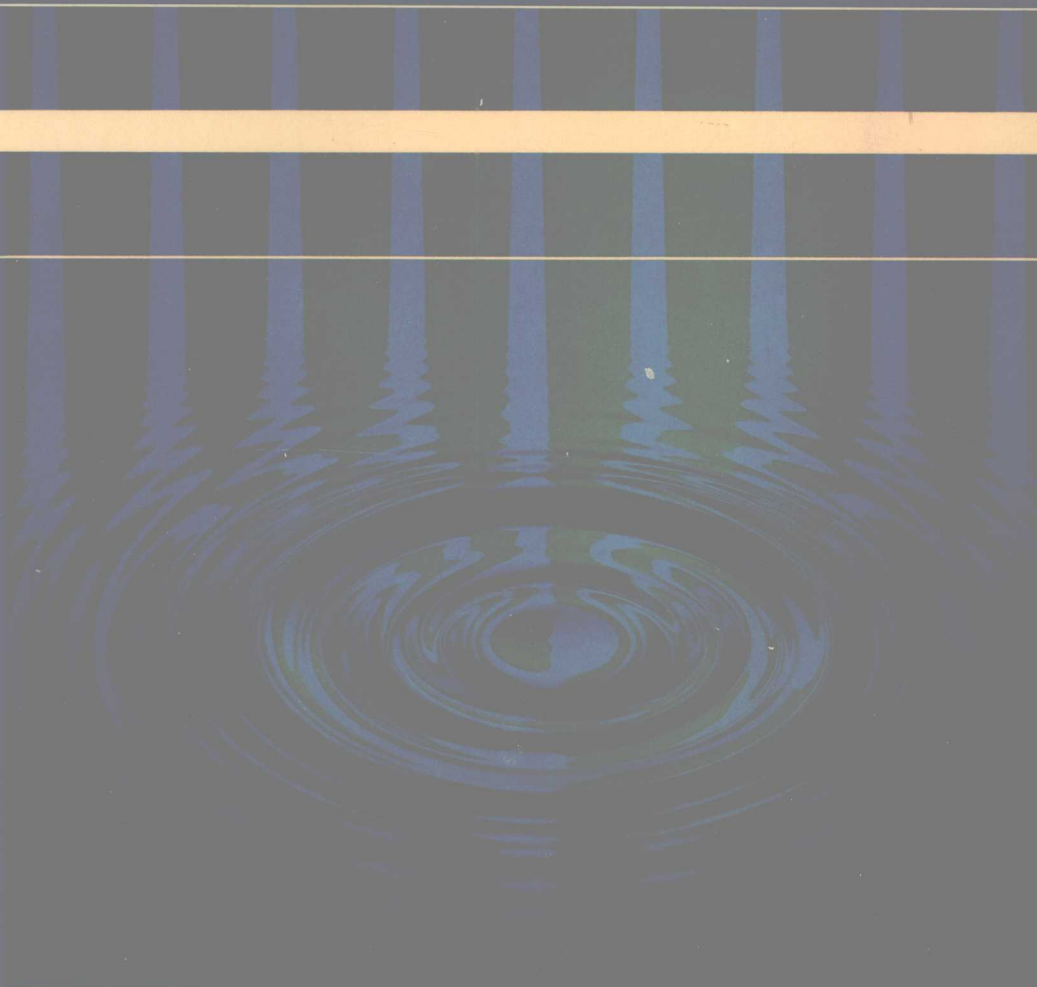




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# UNDERSTANDING ECONOMICS TODAY

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Gary M. Walton / Frank C. Wykoff

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1986

**IRWIN**

Homewood, Illinois 60430

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ISBN 0-256-03223-8

Library of Congress Catalog Card No. 85-81390

*Printed in the United States of America*

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# Preface

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Many people have taken economics and yet have no idea how to apply their education to the problems and issues they confront on a daily basis. How many people say they took economics but remember none of it? The lessons of economics can be used in business, government, medicine, science, the military, law, politics, sports, religion, and virtually any other aspect of modern life. We are amazed and delighted at the ability of our profession to contribute to social well-being in these varied arenas. Indeed, George Stigler, the 1982 Nobel laureate in economics, has called it the “Imperial Science.”



## **TO THE STUDENT**

Your first exposure to economic analysis will be both challenging and rewarding. The tools of economics—objectivity, simplification, modeling, and logic—if well learned will serve you for life. The first step toward sound economic reasoning—learning to distinguish between opinions and analysis—can be difficult. You bring to this first course in college economics notions about capitalism, taxes, regulation, unions, protectionism, and so on. Typically your exposure to these topics came from parents, politicians, popular magazines, and television—sources in which opinions and analyses are often hopelessly entwined. Separating analyses from opinions is a basic principle in this course. It can only be done if the book used is clear, objective, and balanced.

We cover many topics that are vigorously debated, issues over which economists have divergent views and different approaches. We clearly identify these diverse viewpoints and use the simple circular flow model

to show where these different approaches effect our economic output and growth.

We begin with the fundamental tools of choice—demand and supply—for the individual and for the business and see how their choices affect actions in the marketplace. This is *microeconomics*. From decision making by individuals and businesses we proceed to the choices that must be made on a national scope—the issues of inflation, unemployment, and economic growth. This is *macroeconomics*. In *international economics* we examine how U.S. government policies can affect economic conditions worldwide.

Our objective in this book is to help bring some joy and thrill to your study of economics and to provide some basic tools of analysis that you can use to make effective economic choices and to sharpen your insights into local, state, national, and international economic issues.

## TO THE INSTRUCTOR

Teaching objectivity about social issues and at the same time presenting some fundamental tools of analysis is a challenge in a one-semester course. It is impossible to cover all of the topics of economics and include all of the tools. Hard choices must be made; for every tool of analysis presented, an example must be sacrificed. Every practical example studied sacrifices time for tool building. A week devoted to monopoly loses a week to discuss the deficit.

Since each professor's taste for various topics differs, we have built in flexibility to allow choices of emphasis on various topic areas. Still, we start from the premise that the objective of a one-semester economics course is to show how economists think about important issues. Our view is that a basic tool kit for dealing with practical problems is needed. We believe this cannot be done successfully if the course is filled with mathematical equations and daily doses of data tables and graph shifting. Geometry, algebra, statistics, and other tools of the trade should not themselves be barriers—they should be used sparingly and only to support analysis of problems. Thus, we develop only the tools needed to think clearly about the problems most likely studied. In this book we focus on the economic analysis of problems and issues that can be learned in one semester. To this end, we picked problems, examples, and issues that we think capture immediate interest. Our view is that tools are learned most effectively when used to deal with an interesting or important problem.

Another primary aim of this text is to provide a *balanced* perspective. Basic fundamentals of economics are applied to many issues of current and historic interest and divided evenly among the micro, macro, and the international economy sections. Furthermore, there is a balanced perspective in the political rhetoric presented; every effort has been made to make this book politically neutral. To accomplish this, differ-

ences of opinion are noted, revealing where opinion and scientific findings diverge.

We begin in Part I with microeconomics to introduce the traditional tools of economics as applied to individual markets. We present a simple circular flow model to provide the basis for the analysis of product and resource markets, the workings of competitive markets, and the role of government when private markets fail. From there, in Part II, we move to macroeconomics and develop the circular flow model further to show the roles of money, taxes, banking, and government policy. In Part III the topics of international trade and finance are presented.

Despite the long development period for the body of knowledge, or tool kit, known as microeconomics, its development and range of applications continues apace. In recent years two fields in economics—economic history and law and economics—have witnessed extraordinary extensions of scholarly work based primarily on microeconomic theory. The chapters here on microeconomics are written in the spirit of these vibrant fields of applied microeconomics. Although sources of disagreement are noted, the consensus among economists on the theoretical foundations of microeconomics is comparatively strong.

It is widely recognized, however, that there is little consensus among economists on macroeconomic models. Monetarists, Keynesians, new classical macro (rational expectations), supply siders all get pretty excited when discussing each others' papers at conferences. The public dialogues between Feldstein, Friedman, Heller, Stein, Samuelson, Laffer, Thurow, and others is shattering the view that we have a working macro model.

Despite professional differences about an effective macro model, we do have a body of knowledge that students must learn. The basic idea that various markets interconnect in subtle ways is an essential ingredient to national economic policy analysis. Thus, our approach to macro is to first teach the body of information on which we do have consensus—the measures of macro performance, the importance of government budget policy, the role of money and banking in our economy, the consequences of inflation, the importance of unemployment, the difficulties in designing policies to foster growth and stability.

We have dealt as fairly as possible with the different schools of thought about macroeconomic theory and policy. Rather than ignore the topic or present personal views, we use the circular flow model as a vehicle for presenting Keynesian, monetarist, new classical macro, and supply side views. This approach minimizes the mathematics, geometry, and statistics needed, allowing choice on which view best captures the workings of the national economy.

Our approach to macro policy is to explain different views, identifying why they differ. We avoid advocating a specific policy. This allows instructors to develop macro policy issues in a context in which students

can read about the views and critiques of each. We hope professors and students will help us to do a better job by letting us know what works in this book and what does not. Good luck, good learning, and good teaching.

## **Teaching/Learning Aids**

Several elements have been incorporated into each chapter to present an effective teaching/learning package:

- Chapter preview—a situation or description of an event familiar to a student.
- Open-end questions—stimulate thinking and discussion on the subject matter of the chapter.
- Concepts reintroduced—an alphabetical listing of concepts reintroduced with references to the page where the concept is first discussed.
- New concepts—a listing of concepts introduced within the chapter.
- Critical definitions—typographically highlighted and boxed definitions of important concepts placed near the applications and examples that deal with familiar topics.
- Tool kits—the basic principles and tools of analysis used by economists presented and applied in clear step-by-step examples.
- Biography—an influential economist whose work provides a basis for the concept developed in the chapter.
- Figures and tables—clear illustrations with complete interpretation of the concept or data in the caption.
- Chapter review—an overview of the material developed in the chapter.
- Study questions—designed to apply the concepts developed in the chapter.

A complete alphabetical listing of important terms and concepts with definitions appear in the glossary at the end of the text.

**For the Student.** A separate study guide parallels the text. Each chapter contains an approach for study of the material in the chapter, a checklist of concepts and terms, a review of the chapter with fill-in blanks and step-by-step problems, a multiple-choice and true/false self-test (all with answers), problems, and a case study.



**For the Instructor.** An Instructor's Manual provides chapter objectives, lecture notes, teaching suggestions, answers to end-of-chapter questions, and complete answers to the Study Guide questions, problems, and cases. Transparency masters for important graphs and diagrams from the text are included.

An extensive bank of objective test questions carefully designed to provide a fair, structured program of evaluation are available in several formats:

- Irwin Computerized Test Generator System—a convenient and flexible question retrieval device for mainframe systems provides an extensive bank of test questions to use as is or with added questions of your own.
- COMPUTEST—a microcomputer testing system providing convenient and flexible retrieval from an extensive bank of test questions to use as is or with added questions of your own.
- COMPUGRADE—a microcomputer gradebook that stores and prints all grades by name or I.D. number. Capable of weighting and averaging grades.
- TeleTest—a toll-free phone-in service to request customized exams prepared for classroom use.

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## ACKNOWLEDGMENTS

Any book on economics today would be incomplete without discussion of the international economy. For this part of the book, Chapters 19 and 20, we are indebted to our colleague Stephen V. Marks, Assistant Professor of Economics at Pomona college. Economics is indeed a world affair as his chapters make clear.

Marian Brown, Assistant Professor of Economics at Pomona College, is another colleague to whom we are grateful. Her talents for developing a Study Guide filled with lively approaches for learning and applying the concepts of economics will make many students eternally grateful. The material she developed for the Instructor's Manual will lighten the task of many professors.

We are grateful for the many suggestions made by the reviewers of this book:

Elizabeth Elmore, Stockton State College;  
Michael J. Farrell, California State-Long Beach;  
Robert J. Gibbons, Insurance Institute of America;  
Richard Hansen, University of Northern Iowa;

Gene Kimmet, William Rainey Harper College;  
Daniel R. Knighton, Moorehead State University;  
Rodney H. Mabry, Northeast Louisiana University;  
Peter D. Nigro, College of Staten Island;  
Eric J. Solberg, California State–Fullerton;  
Helen Sonenshine, Tidewater Community College;  
Holly Ulbrich, Clemson University; and  
Sydney Wilson, Rockland Community College.

To Jenie Silva, our thanks for clerical assistance, and to Linda Walton, a special appreciation for typing portions of the manuscript.

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Gary M. Walton  
Frank C. Wykoff

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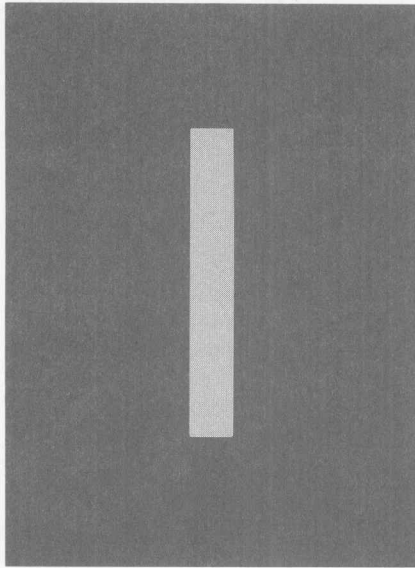
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What are you going to do today? What are your plans for next year? Every day we all make choices on how to spend our time and our money. More wealth and time increase the options and range of choices; but no one has unlimited amounts of these things. Scarcity is a fact of life for all of us. And scarcity imposes costs on us by requiring the sacrifice of one thing (money or time) to get another (a piece of apple pie or a sun tan).

Nations face scarcity too, a scarcity of resources that make choices on national policy inevitable. Nations cannot produce everything for every citizen. Greater defense may require fewer automobiles, perhaps fewer schools or hospitals. Scarcity and choice are central to *economics*, which is the study or science of human behavior in a world of scarcity.

In economics we assume that people pursue what they feel is in their own self-interest. We all prefer more to less and usually make decisions that we hope will improve our well-being. Adam Smith, the father of modern economics, recognized that the strong motivation of self-interest helps to explain and predict human behavior.

You are now embarking on microeconomics—the part of economics that deals with individual and collective choice and decision making in markets. This involves the study of quantities (and quality) of goods and services produced, sold, and bought, and the study of how prices are determined. We shall also see how government policies can affect prices and the quantities exchanged.

Simply stated, the distinction between microeconomics and



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# MICROECONOMICS

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macroeconomics (the next section) is like comparing the small with the large. Microeconomics studies the trees; macroeconomics views the forest as a whole. So in microeconomics we study individual market participants—individual consumers, individual businesses, and individual markets—like the market for home computers or movies or bicycles. Our attentions focus on the parts of the economy rather than on the whole. A key feature of Part I and indeed of the entire book is the role that self-interest plays in determining economic outcomes—what is produced, how it is produced, for whom it is produced.

Some of the material in this part of the book is controversial and generates disagreement. Should government ban boxing? Should smoking be prohibited in public restaurants serving more

than 50 people? What would be the effects on the number and sizes of restaurants? On their prices? Should bank interest rates be controlled, or should banks be allowed to set any rate they choose? What keeps local shoe stores from doubling the price of shoes? Or from cutting them in half?

These and many other issues and questions appear in the chapters ahead. There you will find some, but not all, of the answers; some answers cannot be based on analysis alone. The “right answer” often depends on our individual value judgments of right and wrong, or good and bad. Each of us, reasonable as we may be, can honestly disagree on issues involving values. We hope you will gain useful insights into how the economic forces in our world work.