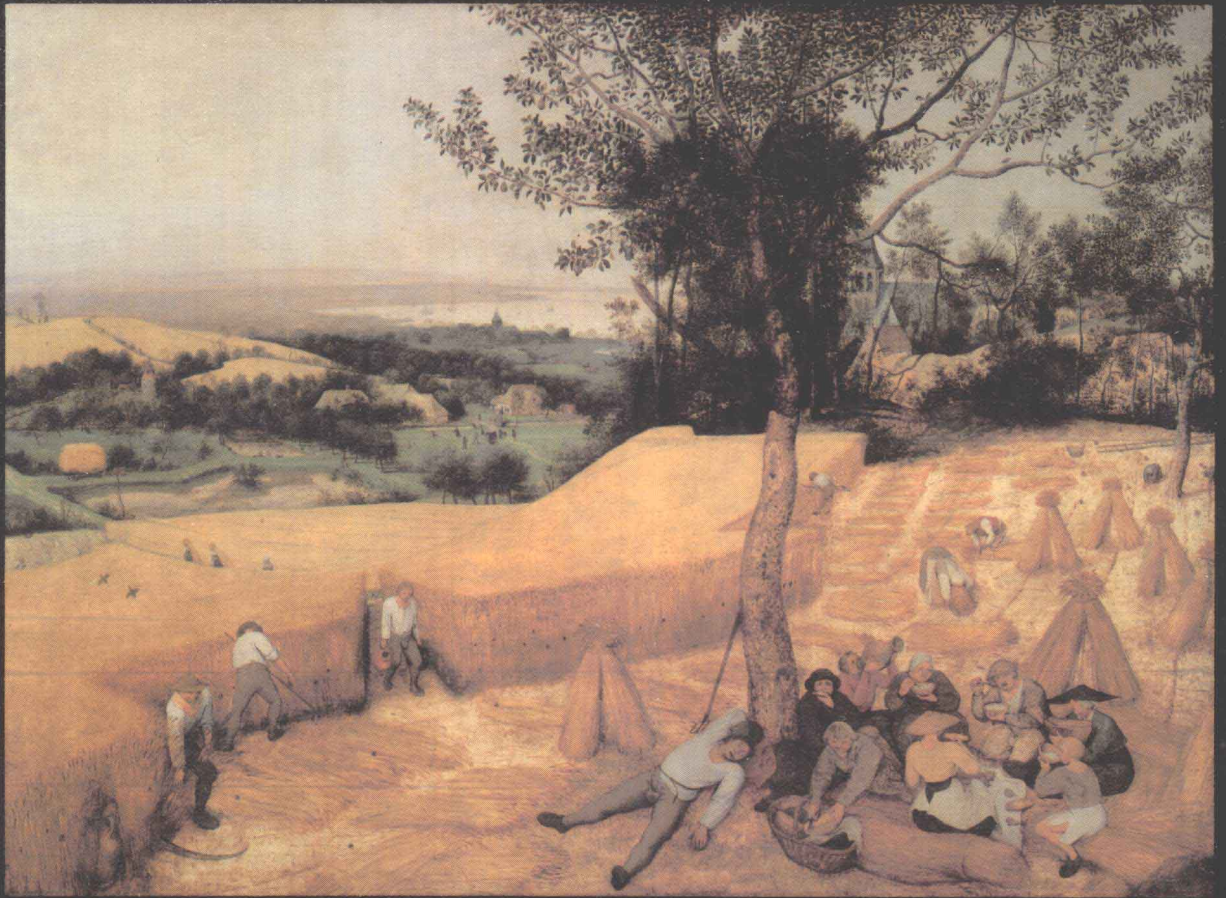
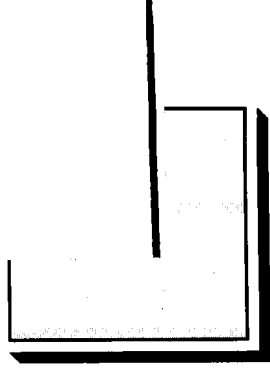


# ECONOM IDEAS & ISSUES

A Systematic Approach  
To Critical Thinking



Jerry Evensky



# **Economic Ideas and Issues**

## **A Systematic Approach to Critical Thinking**

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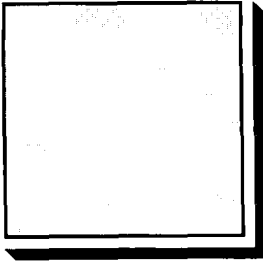
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# Preface

The purpose of this book is to introduce you to the ideas that form the foundation of modern Western (NeoClassical) economic thought, to examine the basic framework (the model) that economists have built on this foundation, and to show how this model is applied to current issues facing individuals and society.

The book is rigorous, but it is not heavily mathematical. The only math skills you will need are basic algebra and geometry. The skills you will need to have carefully sharpened are the ability to reason and to follow the reasoning of others. The most important thing you can learn from this book is how to follow the thread of a powerful argument. By the time you finish it, you should understand and be able to explain and apply the fundamentals of Western mainstream (NeoClassical) economic theory.

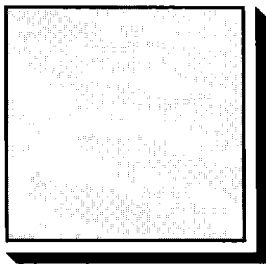
There are a lot of parts to the theory, and each one can be studied in great detail. That is not our objective. We want to recognize the parts, to be able to identify their role in basic terms, and to explain how they all fit together. If we accomplish that goal, you will have an excellent foundation in NeoClassical analysis that you can apply to your study in other fields, to your everyday life as you read the newspaper, and to your participation as a citizen in our representative government. If you find the subject interesting, you will have an excellent foundation for further study within the field.

This book is the product of many hands. Professor Jerry Miner, Chairperson of the Syracuse University Department of Economics, has provided support in the form of resources and encouragement. Without his faith in the project, it would still be only a vision in my mind's eye. Dr. Robert M. Diamond, Syracuse University Assistant Vice Chancellor for Instructional Development, made available the services of the Center for Instructional Development. It was in the offices of CID and with the guidance of its staff that the vision became a design and the design became a product. My guide at CID was Chuck Spuches. Chuck encouraged, challenged, suggested, sup-

ported, facilitated—in short, he made my sloppy handwritten scrawl on yellow legal pages into a book. When Chuck moved on to other challenges, Rob Pearson stepped in and did an excellent job of seeing the work to completion. As the book was being prepared for submission to the publisher, Alton Roberts provided valuable expertise in production of an appropriate manuscript. June Mermigos did all the word processing. Her lovely combination of professionalism and warmth made my life easier and more enjoyable. Martha Strain did all the original graphics. She has a wonderful ability to see with more than her eye. She captured the idea in each of my sketches and transformed it into a clear picture. Jesse Burkhead, the Maxwell Professor of Economics, generously donated his time to reading an earlier version of this text and offering constructive criticism. There are at this point several hundred students who also contributed to this book. Each semester as the development proceeded, they used the text and responded to my inquiries about it with very helpful constructive criticism. I have also benefited greatly from the excellent educational instincts and editorial eyes of the first group of Project Advance teachers to review this text. The last phase of the book's preparation brought me into contact with Bill Webber and Patrick Reynolds, at Prentice Hall. They have combined a solid professionalism with a human touch that I appreciate. I have been blessed with a very special support group. To all of these people I wish to express thanks.

I have tried to create a stimulating book that will serve as a valuable educational tool by informing you and then challenging you to think beyond the information it offers. If it is successful, it will be *our* success—yours for patiently working through the model presented, that of those people named above for their valuable contributions, mine for the effort I put into it, and my wife Celia's for supporting and encouraging me throughout that effort.

This book is dedicated to the memory of Mr. Herbert Behrend. Mr. Behrend taught me algebra, chemistry, and physics in high school, but more than that, he taught me the meaning of vision. He showed me that to study one dimension of human experience is valid only if that study is set into a vision of the many dimensions of experience. In his classroom I learned physics in the context of its history and its relationship to the development of the arts and literature. He was truly a man of vision. I hope that I have honored his memory by communicating some measure of that vision herein.



# Introduction

It seems that a good place to begin this book is with what my wife refers to as a “taster.” While I’m cooking dinner, she’ll come in to ask for a taster—a little taste of whatever it is—so she can tell what dinner will be like. If the taster is good, it whets her appetite for more. If not, she prepares to endure dinner. Here I want to give you a taster of the power of economic theory and its relevance to your life that I hope will whet your appetite for economics.

Generally speaking, economics is about how you and I and everyone else makes choices, and how all of our individual choices affect one another. So the basic issue is choice. Economists assume that the basic motivation for your behavior is a desire to maximize the satisfaction (utility) you get out of life. Economists envision you as deciding each choice by making lightning calculations (generally unconsciously) of the consequences of each available option and the satisfaction you would receive from each set of consequences. You will, according to economists, choose the option that gives you the greatest expected satisfaction. The satisfaction (and dissatisfaction) associated with each available option are the incentives (and disincentives) to choose that option. Thus you and I make choices on the basis of the incentives we face—and so it is for everyone.

Let’s take an immediate case in point. You have chosen to spend some of your time studying this book. (Remember the phrase “spend time.” It should take on new meaning as you spend more time reading this book.) Why do you choose to spend your time studying?

When you were in the seventh grade, if you studied at all, it was probably at least in part because your parents either punished you for not studying or rewarded you for doing so. In other words, whatever studying you did was in response to the incentives you faced:

“If you don’t have that report written, you’re not going to the party on Saturday.”

OR

“If the report is written by Saturday, we’ll take you to the movies.”

You still respond to incentives, but now both you and the kinds of incentives you face have changed dramatically. You have toiled through many years of school, you are in the prime of your life, your parents have much less leverage over you—so why do you choose to go on to more pressure and more toil? Why are you in college, sitting here reading an assigned text? It's not required by law, your parents can't make you, and there are other good ways to spend your time. You could get a job, start earning a living immediately, and after supper you wouldn't have to hit the books. You could start enjoying life now. Why are you putting yourself through this grind instead?

According to economic theory, by making this choice, you have revealed that, of all the available options, you prefer college. This choice (college) must, therefore, give you more satisfaction (utility) than any of the available alternatives. Yet anyone who's been there knows that college can be an exhausting, nerve-wracking, even a brutal experience. Why would anyone "prefer" college?

Economists have an explanation that includes three parts. First of all, some people derive immediate satisfaction from exploring and learning new ideas, from meeting new people from places they've never been, from going to parties and athletic events, or from some combination of these elements of college life. If any one of these applies to you, then your attendance can be explained, at least in part, by these incentives. You are, in economic terms, consuming (deriving immediate satisfaction from) college.

There is also an investment aspect to attending college. School is like any other investment. You pay now in order to reap benefits (satisfaction) later. Your current payment is made in three ways. There's the direct payment (tuition, room, and board), there's the indirect payment (earnings you forgo by not taking a job immediately after high school), and there is the payment in kind (sweat and blood). Your benefit from the investment is the *likelihood* (remember, with any investment there is risk) that your future income and lifestyle, and therefore your future satisfaction in life, will be better than they would have been if you had started working directly out of high school.

Since it's unlikely that the consumption aspects alone attract most people to college, most of you are probably making an investment. The second and third parts of an economist's explanation of your decision relate to choice as an investment. Economists explain this investment in two ways:

1. *Human capital theory.* Human capital theory simply extends the logic of capital investment from machines to humans. We invest in education for the same reason we invest in machines; it makes us

more productive. Being more productive means high earnings. Thus we spend money directly (tuition) and indirectly (forgone earnings) now in order to make more money later. So long as the rate of the return on the human capital investment is enough to convince us to forgo current consumption—and is at least as good as alternative investments—we choose school.

2. *Signaling theory.* Those who hold this alternative view of the human investment process argue that school doesn't make us more productive, it just allows us to signal our superior productivity. According to this view, people who are more productive (owing to genetics, dedication, or determination) need a way to signal that difference to prospective employers. A college diploma serves as such a signal. If nothing else, it tells employers that you have the ability to stay at a long and sometimes difficult task until it is done.

Notice that the three parts of this explanation are not mutually exclusive. You may be in college to acquire productive skills *and* because you believe a college degree is a useful signal, *but* you may also be enjoying the process and the environment.

Thus economic theory of educational choice helps us understand why people choose school. Consider yourself. Why are you here? If you think about it, you'll probably find that the theory provides a very useful explanation of your own behavior. Even more impressive and useful is the fact that the theory can also help us predict behavior.

While an economist studying the behavior of prospective college students won't have a lot of information on any one individual, she can often get some basic information on a lot of individuals—a class or a generation. With this information and the economic theory of educational choice outlined above, an economist can often make some generally accurate and useful predictions about the behavior of the group as a whole.

For instance, if it is correct that most students think of college in large measure as an investment, then it must also be true that students' choices of majors will reflect their expectations about the kinds of jobs to which those majors will lead. Using the theory, we can predict, therefore, that as expectations about job prospects change, so will college students' choices of majors.

This is a simple application of the basic premise that choices are made on the basis of incentives. Clearly, as incentives change, choices will change. To continue our example, if getting a good job is a primary incentive for attending college and if job prospects change, then the major that students choose at college should change in response to the changed incentives. Evidence seems to support the theory.



In the 1960s the baby boom generation was moving into and through the public schools. That created a lot of teaching opportunities. In response to this incentive, college students flowed into departments of education, confident that plenty of opportunities awaited them when they finished. As the bulge of baby boomers passed out of the schools, the opportunities in education contracted. In response to this change in incentives, students entering college began to flow into departments other than education.

During the 1980s there has been a significant increase in the number of college students choosing business-related majors. This presumably reflects a perception on their part that there are good opportunities and salaries to be had in business. If this increasing supply of business majors expands faster than the demand, then eventually the number and quality of opportunities available to each graduating business major will decline. As that happens, other opportunities will begin to be relatively more attractive—in other words, the structure of incentives will change. When this new perception about future opportunities filters its way through college and high school campuses, students will adjust their behavior accordingly by moving into majors that lead to the newly blossoming opportunities. The chart below reflects the change in choice of majors from the early 1970s to the early 1980s.

### **'In' and 'Out' Degrees**

The latest figures from the United States Department of Education on undergraduate fields of study confirm that today's college students are keeping their eyes glued to the job market. Business and management, which ranked behind education and the social sciences in the number of degrees awarded in 1974, surged ahead by 1984. Other large gainers were computer and information science, communications and engineering — degrees that can immediately result in jobs. Losers were traditional liberal-arts specialties, such as education, literature, language study, philosophy and religion.

#### **Bachelor's degrees conferred by institutions of higher education**

Program Areas	1973-74	1983-84	% Change*
Business and Management	131,766	230,031	75%
Communications	16,250	38,586	137
Computer and Info Sciences	4,756	32,172	576
Education	185,225	92,382	-50
Engineering	42,840	75,732	77
Foreign Languages	18,840	9,479	-50

Program Areas	1973-74	1983-84	% Change*
Health Sciences	41,394	64,338	55
English	55,469	33,739	-39
Library and Archival Sciences	1,164	255	-78
Life Sciences	48,340	38,640	-20
Mathematics	21,635	13,211	-39
Philosophy and Religion	9,444	6,435	-32
Physical Sciences	21,178	23,671	12
Psychology	51,821	39,872	-23
Social Sciences	150,298	93,212	-38

\* Minus indicates declines *Source Center for Statistics. U.S. Department of Education The New York Times, Aug. 3, 1986*

By understanding the direction and degree of responsiveness individuals exhibit when their opportunities and thus their incentives change, economists are able to make predictions about an individual's or a group of individuals' response to a particular opportunity change. The ability to make that sort of prediction is often very valuable. Consider the military draft.

Right now the United States has no draft. When it did have one, the military could compel you to show up and serve your country. Since your option was to show up or to go to jail, the incentive to show up when called was strong. The military had no need to create a pay incentive to get you, the incentive to participate was a very effective stick (Fort Leavenworth—the prison). There was no need for the military to offer a carrot (high pay). However, when the draft was eliminated, the situation changed dramatically. There was no longer a stick. In order to get men and women to join, the military had to make that choice appealing enough so that an adequate number of eligible young people would choose it over all other available opportunities.

When unemployment is high, recruiting is not very difficult. After all, during hard times, there are not many other decent opportunities for young people. However, when the national economy is strong, just the opposite is true. The military must compete with lots of good opportunities by offering better pay and benefits, and by advertising what a great job it is.

If the United States gets involved in another conventional war, the need for recruits will expand rapidly. In order to meet their requirements the military services will either have to increase the benefits of serving (which is very expensive), appeal to everyone's patriotism (which in most wars hasn't produced enough enlistments), or reinstate the draft. This prediction is based on economic theory. So, you

see, even the draft—and most of you are draft age—has an economic dimension.

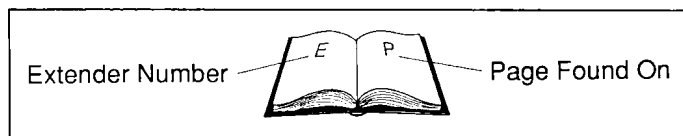
In fact, almost everything you do has an economic dimension. That would be true even if you lived all by yourself like Robinson Crusoe, because you would still have to make choices. The economic dimension of your life is all the more complex because, unlike Crusoe, you live in a world of human interaction; that is, your choices affect the choices made by others and vice versa. It is this pervasiveness of economics—the fact that it is such a fundamental part of our lives—that makes it such an interesting and important subject.

When you look out the window at the world, it seems so complicated. As you sit here, it may even seem scary. You have hopes and dreams. Surely your mind wanders from the immediate world to that imaginary world of what you'd like to be and do, and you wonder to yourself: "How do I get there from here? Am I wasting my time in school? What should I be doing?"

Well, the world is complicated and this text can't make it any less so. But it can help you understand the world a bit better and maybe if you understand it better you will be less threatened by it and more empowered to shape your own future. As the text will make clear, some forces are within your control (you are free to make some choices) and other forces are beyond your control (they constrain the opportunities from which you can choose). No human being can ever have absolute control over his or her destiny, but the more you understand about how the world works, the more effectively you can use the power you do have.

This book is written to help you understand "how the world works." Economics is not the whole story of how the world works; there are also social, political, ethical, and natural forces that move the world. It is, however, a very important part of that story.

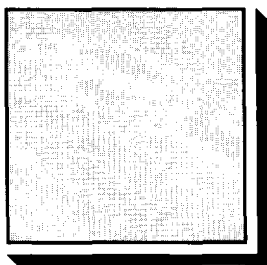
At the end of the body of the text is a lengthy section called "Extenders." These are provided, as the name implies, to extend the content of the text. They were placed at the end of the book so they would not interrupt the flow of the logic developed in the body of the text. As you read through the text, you will see marginal notes that refer you to the extenders. The note will appear as shown in Figure 0-1. These notes provide an unobstrusive signal that the subject being covered is extended in the appendix.



**FIGURE 0-1**

There are three kinds of extenders:

1. *Technical*: These provide a more rigorous graphical analysis of a relationship derived in the body of the text. If you plan to take courses beyond the introductory level, you should master these techniques.
2. *Conceptual*: These present a more detailed look at a concept covered in the body of the text.
3. *Newspaper articles*: These show how the content of the text can be applied to reading the newspaper. The articles are not current—it is impossible for a publication other than today's newspaper to have today's news. Rather, they were chosen for their generic value. If you see how the content of the text applies in the articles examined, you should be able to do a similar application to issues making the daily news as you are reading the text. Buy the newspaper and try to do this as you read the text. If you master that application of your knowledge, the content of the text will be of permanent value to you.



# Overview

This Overview is written to serve two purposes. As you begin, it gives you an impression of the course we will follow. Later, as we are making our way through that course, it will serve as your verbal map. You should reread the Overview as you work your way through the text in order to put each new issue we examine in a larger perspective, thus constantly orienting yourself.

In order to accomplish our purpose, we will follow the Western mainstream (NeoClassical) channel in economic thought. Our course will begin in general philosophy, move on to basic NeoClassical microeconomic theory, and then to basic NeoClassical macroeconomic theory. At the end of our journey we will look back and critically examine the NeoClassical model we have studied.

We begin with general philosophy because the first question we must answer is: Why do scientists build models? We are, after all, about to spend a lot of time examining one such model, so it is reasonable to begin with this question. Once we convince ourselves that model building is worthwhile, we will then spend some time examining how it is done. It is much easier to understand a model, to recognize its strengths and weaknesses, if you know how it was built.

When this very general philosophical background is complete, we will narrow our focus a bit and look at the specific issues involved in social science model building. There are problems in social science model building that most natural sciences do not face, and there are even some problems that are unique to social science models. We want to identify those problems so that we can be aware of their potential impact on the economic model we will study. From the broad social science perspective we will narrow our focus further to the field of economics. In order to do so we will distinguish economics from the other social sciences by identifying the basic issue that gives rise to economic questions: the “quandary of choice.”

Having specified and explained the basic questions that economists seek to answer about society, we will begin our analysis in the context

of the simplest of societies: a Robinson Crusoe society (i.e., a one-person society). In this context we will build a simple economic model. As we shall see, the model of this simple world is almost trivial, but not quite so. It does, at least, give us a basic framework for the systematic analysis of our basic economic questions. This will prove useful when we turn our attention to a much more complicated context: a complex society.

A complex society is one in which there are a number of interdependent individuals. Our study of this society will begin with an examination of the forces that give rise to interdependence. Why, we will wonder, do individuals give up independence and accept the vulnerability that comes with interdependence? Our guide in answering this question will be Adam Smith, the man who, in 1776, wrote the first basic, full-scale work in economics, *The Wealth of Nations*. From him we will learn why simplicity gives way to complexity in a society and how markets can serve as a mechanism for coordinating individual choice decisions so that complexity does not become a road to chaos.

After this introduction to complexity by Adam Smith we will turn our attention to the model of individual behavior in a complex society (a “micro” model) presented by the father of modern NeoClassical microeconomic theory, Alfred Marshall (*Principles of Economics*, 1890). The microeconomic model that Marshall proposed is in its essentials the one NeoClassical theorists still use today. We will develop the basic model and apply it to some current issues in order to see it in action. We will find that the policy implications of the micro model depend on how well one believes the market system works and how coherently one believes policy can be organized.

When we complete our study of the microeconomic model we will look at the economy from a different perspective. Rather than looking through a microscope at the actions and interactions of individuals, we will examine the economy at the level of society as a whole. This latter perspective is called a “macro” view. We will develop a model of the macroeconomy. As we do so, we will pay special attention to the logical connections between the micro- and macroeconomic models. During our development of the macro model, we will refer to actual macroeconomic data and consider that information in light of our analyses. We will begin by studying the nation’s macroeconomy in isolation, and then we will expand our model to include the impact of international trade.

When we have completed the macro model, we will examine its implications under varying assumptions about the microeconomic system. We will see that the basic macroeconomic model is consistent with different interpretations depending on the assumptions one makes about how well the microeconomic system works. These dif-

ferent interpretations are the basis for the debate at the cutting edge of current economic theory, and are fundamental to the different policy prescriptions that you are currently reading about in the newspaper or hearing espoused by various economists and political leaders on television.

We will see that there is a continuum of views within the NeoClassical mainstream, and that this continuum can be represented by identifying its two poles. The economists at one pole believe that the complex system is analogous to the simple Robinson Crusoe system. They view the system as self-correcting and believe, therefore, that there is no need for government intervention. The economists at the other pole contend that, unlike the simple system, the complex system does not always self-correct. As a result, they believe that there can be breakdowns in the aggregate economy (e.g., unemployment) that may make government intervention necessary.

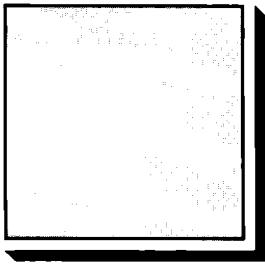
Once we identify the microeconomic foundations of this macroeconomic policy debate over whether the government should intervene, we will turn our attention to how government does, by design or accident, influence the economy. The major influences we will examine are monetary policy (the supply of money the government generates), fiscal policy (the government's spending and taxation policy), and international trade policy. In each case we will identify the government institution(s) that exert(s) some control over these policies, and how that control is exercised. As each macroeconomic institution is introduced, we will present the opposing noninterventionist and interventionist views on what the policy of that institution should be.

Having examined the basis for the debate within the NeoClassical mainstream, we will review the evolution of that debate in the history of mainstream theory and the current state of that debate. We will find that prior to John Maynard Keynes, the traditional or Classical theorists generally held that, although the model of a complex society was more complicated than that for a simple society, the same basic principles applied whether the model was applied in a simple Robinson Crusoe society or a complex society. Keynes rejected this extrapolation from simple to complex, arguing instead that a complex society was by the very nature of its complexity fundamentally different in the aggregate. Keynes's book, *The General Theory of Employment, Interest and Money* (published in 1936), refocused attention on macroeconomic (aggregate) issues. Since *The General Theory* a large number of economists have turned their attention to macroeconomic theory. We will find that in more recent times there has been a resurgence of the traditional or Classical (as Keynes referred to it) view. This new view is referred to as the New Classical or the Rational

Expectations perspective. We will examine this new view and contrast it with its primary competitor—the Keynesian view.

Upon completion of our study of NeoClassical micro- and macro-economic theory, we will look at the problems of testing the model that make it possible for two opposing versions of mainstream theory to coexist, one unable to clearly prove its superiority over the other. Finally, we will conclude with some thoughts on why all this is so important for our future.





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