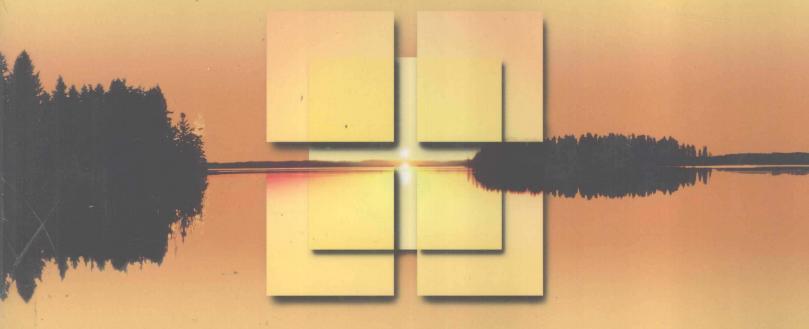
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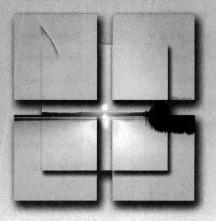


Robin Bade

Michael Parkin

ESSENTIAL FOUNDATIONS OF ECONOMICS

Second Edition



Robin Bade



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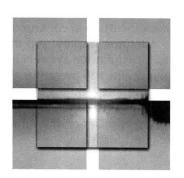
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Preface



We began the preface to our first edition of *Foundations of Economics* by attempting to answer a question that we thought would be on many people's minds: *Why*? With Michael's book, *Economics*, Sixth Edition, an established, best-selling text, why on earth would we write a new book?

In retrospect, as we publish the Second Edition of Foundations of Economics and its companion volume, Essential Foundations of Economics, we find ourselves wondering more and more why we didn't write Foundations sooner. The response from the economics community

has been tremendous. Clearly, many of you agree with our view that

- Most introductory economics textbooks try to do too much;
- Students too frequently get lost in a sea of detail; and
- · Economics is a subject that can be learned only by doing it.

We have encountered this view from our own students, and we have heard it echoed by literally hundreds of colleagues across the United States and throughout the world. But creating a teaching and learning system that takes this view seriously is no easy task. *Foundations of Economics* is the result of our best effort to do so and to help students and teachers meet the challenges we all face.

LOWERING THE BARRIERS TO ENTRY

Most economics professors want to teach a serious, analytical course that explains the core principles of our subject and helps students apply these principles in their lives and jobs. We are not content to teach "dumbed-down" economics. But most students drown rather than learn to swim when thrown into the deep end of the pool. In this book and its accompanying learning tools, we make painstaking efforts to lower the barriers to learning and to reach out to the beginning student.

We focus on core concepts. We steer a steady path between an overload of detail that swamps the students and a minimalist approach that leaves the student dangling with too much unsaid. We explain tough concepts with the simplest, most straightforward language possible, and we reinforce them with clear, fully explained graphs. And we offer students a rich array of active learning tools that provide alternative ways of accessing and mastering the material.

FOCUS ON CORE CONCEPTS

Each chapter of *Essential Foundations* concentrates on a manageable number of main ideas (most commonly three or four) and reinforces each idea several times throughout the chapter. This patient, confidence-building approach guides students through unfamiliar terrain and helps them to focus their efforts on the most important tools and concepts of our discipline.

■ DIAGRAMS THAT TELL THE WHOLE STORY

We developed the style of our diagrams with extensive feedback from faculty focus group participants and student reviewers. All figures make consistent use of color to show the direction of shifts and contain detailed, numbered captions designed to direct students' attention step by step through the action. Because beginning students of economics are often apprehensive about working with graphs, we have made a special effort to present material in as many as three ways—with graphs, words, and tables—in the same figure. And in an innovation that seems necessary but is to our knowledge unmatched, nearly all of the information supporting a figure appears on the same page as the figure itself. No more flipping pages back and forth!

MANY LEARNING TOOLS FOR MANY LEARNING STYLES

Our text and its integrated print and electronic learning package recognize that students have a variety of learning styles. Some learn easily by reading the text-book; others benefit from audio and visual reinforcement. All students can profit from an active learning approach. Your students' textbooks come with access to a suite of innovative learning tools, including tutorial software, an eText featuring animated graphs with audio voiceovers, interactive quizzes, and more.

PRACTICE MAKES PERFECT

Everyone agrees that the only way to learn economics is to do it! Reading and remembering doesn't work. Active involvement, working problems, repeated self-testing: These are the ingredients to success in this subject. We have structured this text and its accompanying electronic and print tools to encourage learning by doing. The central device that accomplishes this goal is a tightly knit learning system based on our innovative *Checklist-Checkpoints* structure.

CHECKLISTS

Each chapter opens with a *Chapter Checklist*—a list of (usually) three or four tasks the student will be able to perform after completing the chapter. Each Checklist item corresponds to a section of the chapter that engages the student with a conversational writing style, well-chosen examples, and carefully designed illustrations.

CHECKPOINTS

A full-page *Checkpoint*—containing a Practice Problem with solution and a parallel Exercise—immediately follows each chapter section. The Checkpoints serve as stopping points and encourage students to review the concept and to practice using it before moving on to new ideas. Diagrams and tables bring added clarity to the Checkpoint problems and solutions.

Each Checkpoint also contains a page reference to the corresponding material in the Study Guide as well as a reference to the corresponding section of our online learning environment. We describe these learning tools more fully below.

CHAPTER CHECKPOINTS

At the end of each chapter, a *Chapter Checkpoint* summarizes what the student has just learned with a set of key points and a list of key terms. It also contains a further set of questions divided into three groups: exercises, critical thinking, and Web exercises.

■ CONVEYING THE EXCITEMENT

Students learn best when they can see the point of what they are studying. We show the point in a series of *Eye On...* features. Current and recent events appear in *Eye on the U.S. Economy* boxes. We place our present experience in global and historical perspectives with *Eye on the Global Economy* and *Eye on the Past* boxes. All of our *Eye On...* boxes connect theory with reality.

ORGANIZATION

Our text focuses on core topics with maximum flexibility. We cover all the standard topics of the one-term principles of economics curriculum. And we do so in the order that is increasingly finding favor in the principles course. We believe that a powerful case can be made for teaching the subject in the order in which we present it here.

We introduce and explain the core ideas about efficiency and fairness early and then cover major policy issues using only the tools of demand and supply and the ideas of marginal benefit, marginal cost, and consumer and producer surplus. Topics such as cost curves, which are more technical, are covered later.

Deciding the order in which to teach the components of microeconomics involves a tradeoff between building all the foundations and getting to policy issues early in the course. There is little disagreement that the place to begin is with production possibilities and demand and supply. We provide a carefully paced and thoroughly modern treatment of these topics.

Following the order of this text, the course quickly gets to interesting policy issues. Two further chapters lay the foundation: elasticity in Chapter 5 and a discussion of the efficiency and fairness of markets in Chapter 6. Introducing students to both efficiency and fairness (equity) issues early in the course enables a more complete and engaging discussion of topics such as taxes, price floors, price ceilings, and externalities, all of which we cover in Chapters 7 and 8. Teaching this material early in the course maintains student interest, directly serves the role of the principles course as a foundation for citizenship, and

provides an immediate payoff from learning the demand-supply and related tools. Only when these policy issues have been covered do we dig more deeply behind the consumption and production decisions.

Teachers who prefer to cover policy issues later in the course can skip Chapters 6 through 8 and move straight from elasticity to the economics of the firm. The policy-related chapters can be covered at any chosen point later in the course.

Our coverage of macroeconomics is organized in two parts: Monitoring the Macroeconomy and Understanding the Macroeconomy. We provide three solid chapters that deal respectively with measuring real GDP and the standard of living (Chapter 13); measuring the CPI and the cost of living (Chapter 14); and measuring the state of the labor market and fluctuations around full employment (Chapter 15).

The chapters that explain macroeconomic performance exploit the idea that at full employment, the real economy is influenced by only real variables and the price level is proportional to the quantity of money. So Chapter 16 explains economic growth and Chapters 17–19 explain the monetary system and long-term inflation trends. Away from full employment, real variables and nominal variables interact to bring the business cycle. Chapter 20 explains the cycle using the *AS-AD* model and Chapter 21 studies the use of monetary and fiscal policy to stabilize the business cycle.

By providing a firm understanding of the forces that determine potential GDP and long-term growth, the student better appreciates the more complex interactions of real and monetary factors that bring economic fluctuations. Further, the student sees that the long-term trends in our economy play a larger role in determining our standard of living and cost of living than do the fluctuations around those trends.

Extensive reviewing suggests that most teachers agree with our view on how to organize the course. But we recognize that there is a range of opinion about sequencing, and we have structured our text so that it works equally well if other sequences are preferred. Some teachers want to follow the measurement material with aggregate supply and aggregate demand, then money and the price level and finally economic growth. Our text supports this sequence. After Chapter 14, it is possible to jump to Chapter 20 (*AS-AD* and the Business Cycle). The money chapters (17, 18, and 19) can be covered next, followed by stabilization policy (Chapter 21).

A RICH ARRAY OF SUPPORT MATERIALS FOR THE STUDENT

Essential Foundations of Economics is accompanied by the most comprehensive set of learning tools ever assembled. All the components of our package are organized by Checkpoint topic so that the student may move easily between the textbook, the Study Guide, eText, interactive tutorial, and online diagnostic quizzes, while mastering a single core concept.

The variety of tools that we provide enables students to select the path through the material that best suits their individual learning styles. The package is technology-enabled, not technology-dependent. Active learners will make extensive use of the *Foundations Interactive* tutorial and the animated graphics of eText, our online version of the textbook. Reflective learners may follow a print-only path if they prefer.

STUDY GUIDE

Tom Meyer of Patrick Henry Community College, Neil Garston and Tom Larson of California State University, Los Angeles, and Mark Rush of the University of Florida have prepared a Study Guide that is available in both print and electronic formats. The Study Guide provides an expanded Chapter Checklist that enables the student to break the learning tasks down into smaller, bite-sized pieces; self-test materials; expanded explanations of the solutions to the practice problems in the text; and additional practice problems. To ensure consistency across the entire package, the authors who wrote the questions for the Test Bank also wrote the self-test questions for the Study Guide.

■ FOUNDATIONS INTERACTIVE

A Java and JavaScript tutorial software program that runs in a Web browser, Foundations Interactive contains electronic interactive versions of most of the text-book figures. The student manipulates the figures by changing the conditions that lie behind them and observes how the economy responds to events. Quizzes that use five question types (fill-in-the-blank, true-or-false, multiple-choice, complete-the-graph, and numeric) can be worked with, or optionally without, detailed feedback. Foundations Interactive is available through the Foundations Web site, within the MyEconLab course, and on CD-ROM.

■ FOUNDATIONS WEB SITE

The Foundations Web site is a powerful and tightly integrated online learning environment. For students, the site includes

- eText—the entire textbook in PDF format with hyperlinks to all the other components of the Web site with video clips and animated figures accompanied by audio explanations prepared by us
- · eStudy Guide—the entire Study Guide online
- Foundations Interactive—tutorials, quizzes, and graph tools that with a click of the mouse make curves shift and graphs come to life
- Diagnostic quizzes for every Checkpoint with feedback that includes hyperlinks to the e-text, e-Study Guide, and Foundations Interactive
- Economics in the News updated daily during the school year
- Online "Office Hours"—ask a question via email and one of us will respond within 24 hours!
- Economic links—links to sites that keep students up to date with what's going on in the economy and that enable them to work end-of-chapter Web exercises

■ MyEconLab COURSE

MyEconLab delivers the entire content of the Foundations Web site in a course management system. Students whose instructors use MyEconLab gain access not only to the resources of the Foundations Web site, but also to

 MathXL for Economics—a powerful tutorial to refresh students on the basics of creating and interpreting graphs, solving applied problems using graphs, calculating ratios and percentages, performing calculations, calculating average, median and mode, and finding areas.

- Research Navigator[™]—a one-stop research tool, with extensive help on the entire research process, including evaluating sources, drafting, and documentation, and access to a variety of scholarly journals and publications, a complete year of search for full-text articles from the *New York Times*, and a "Best of the Web" Link Library of peer-reviewed Web sites.
- eThemes of the Times—thematically related articles from the *New York Times* accompanied by critical thinking questions.

The Student Access Kit that arrives bundled with all new books walks students step-by-step through the registration process.

■ THE ECONTUTOR CENTER

Staffed by qualified, experienced college economics instructors, the Econ Tutor Center is open five days a week, seven hours a day. Tutors can be reached by phone, fax, and e-mail. The Econ Tutor Center hours are designed to meet your students' study schedules, with evening hours Sunday through Thursday. Students receive one-on-one tutoring on examples, related exercises, and problems. Please contact your Addison-Wesley representative for information on how to make this service available to your students.

■ ECONOMIST.COM EDITION

The premier online source of economic news analysis, economist.com provides your students with insight and opinion on current economic events. Through an agreement between Addison-Wesley and *The Economist*, your students can receive a low-cost subscription to this premium Web site for 3 months, including the complete text of the current issue of *The Economist* and access to *The Economist's* searchable archives. Other features include web-only weekly articles, news feeds with current world and business news, and stock market and currency data. Professors who adopt this special edition will receive a complimentary one-year subscription to economist.com.

■ THE WALL STREET JOURNAL EDITION

Addison-Wesley is also pleased to provide your students with access to *The Wall Street Journal*, the most respected and trusted daily source for information on business and economics. For a small additional charge, Addison-Wesley offers your students a 10-week subscription to *The Wall Street Journal* print edition and *The Wall Street Journal Interactive Edition*. Adopting professors will receive a complimentary one-year subscription of both the print and interactive versions.

■ FINANCIAL TIMES EDITION

Featuring international news and analysis from FT journalists in more than 50 countries, the *Financial Times* will provide your students with insights and perspectives on economic developments around the world. The *Financial Times Edition* provides your students with a 15-week subscription to one of the world's leading business publications. Adopting professors will receive a complimentary one-year subscription to the *Financial Times* as well as access to the Online Edition at FT.com.

A QUALITY-ASSURED SUPPORT SYSTEM FOR THE INSTRUCTOR

Our instructor resource tools are the most comprehensive, carefully developed, and accurate materials ever made available. *Foundations Interactive*, the Study Guide, the diagnostic quizzes on the Foundations Web site, the PowerPoint lecture notes, the Instructor's Manual, and the Test Banks, all key off the Checkpoints in the textbook. The entire package has a tight integrity. We are the authors of *Foundations Interactive*, the diagnostic quizzes, and PowerPoint notes. We have paid close attention to the design, structure, and organization of the Web site. And we have helped in the reviewing and the revising of the Study Guide, Instructor's Manual, and Test Banks to ensure that every element of the package achieves the consistency that students and teachers need.

INSTRUCTOR'S MANUAL

The Instructor's Manual contains chapter outlines and road maps, answers to intext exercises, additional exercises with solutions, and a virtual encyclopedia of suggestions on how to enrich class presentation and use class time efficiently. The micro portion has been written by Carol Dole (State University of West Georgia) and Mark Rush, and the macro portion has been written by Richard Gosselin (Houston Community College) and Mark Rush.

THREE TEST BANKS

Three separate Test Banks are available for Essential Foundations of Economics, with more than 5,000 multiple-choice, true-false, numerical, fill-in-the-blank, short-answer, and essay questions. New to this edition, integrative questions build on material from more than one Checkpoint or more than one chapter. Mark Rush reviewed and edited questions from seven dedicated principles instructors for microeconomics and six for macroeconomics to form one of the most comprehensive testing systems on the market. Our questions authors on the micro side are Seemi Ahmad (Dutchess Community College), Sue Bartlett (University of South Florida), Jack Chambless (Valencia Community College), Carol Dole (State University of West Georgia), Paul Harris (Camden County Community College), William Mosher (Assumption College), and Terry Sutton (Southeast Missouri State University). Our questions authors on the macro side are Ali Ataiifar (Delaware County Community College), Diego Mendez-Carbajo (Illinois Wesleyan University), William Mosher (Assumption College), Terry Sutton (Southeast Missouri State University), Cindy Tori (Valdosta State University), and Nora Underwood (University of California-Davis). These Test Bank authors also wrote questions for the Study Guide to ensure consistency.

POWERPOINT RESOURCES

We have created the PowerPoint resources based on our 10 years of experience using this tool in our own classrooms. Every figure and table—every single one, even those used in Checkpoint questions and solutions—is included in the PowerPoint lecture notes, many of them animated so that you can build them gradually in the classroom. Key figures can be expanded to full screen size or shrunk to make space for text explanations at a single mouse click during a

lecture. We have determined the optimal build sequence for the animated figures and produced them with the same degree of clarity and precision as the figures in the text.

The speaking notes sections of the PowerPoint files provide material from the Instructor's Manual on teaching tips and suggestions.

MyEconLab

Custom built for *Essential Foundations*, MyEconLab delivers all of the interactive resources available on the Foundations Web site in a comprehensive online course. With MyEconLab, instructors can customize existing content and add their own. They can manage, create, and assign tests to students, choosing from our extensive test bank, or upload tests they've written themselves. MyEconLab also includes advanced tracking features that record students' usage and performance, and a Gradebook feature to see students' test results. In addition, the instructor will find short video clips for each chapter—ideal for sparking classroom discussion or motivating lectures. Please refer to the Instructor Quick Start Guide or contact your Addison-Wesley sales representative to set up your course.

VIDEOS

In addition to the short video clips mentioned above, a comprehensive series of lecture videos accompanies the text. The videos follow the same Checklist-Checkpoint format as the book itself, and feature presentations by Robin Bade, Michael Parkin, Kaya Ford (Northern Virginia Community College), Gary Latanich (Arkansas State University), Kirk Gifford (Brigham Young University, Idaho), and Carol Dole (State University of West Georgia). The videos are available on VHS tapes and on CD-ROM.

OVERHEAD TRANSPARENCIES

Full-color overhead transparencies of *all* figures from the text will improve the clarity of your lectures. They are available to qualified adopters of the text (contact your Addison-Wesley sales representative).

■ INSTRUCTOR'S RESOURCE DISK WITH COMPUTERIZED TEST BANKS

This CD-ROM contains Computerized Test Bank files, Test Bank and Instructor's Manual files in Microsoft Word, and PowerPoint files. All three Test Banks are available in Test Generator Software (TestGen-EQ with QuizMaster-EQ). Fully networkable, it is available for Windows and Macintosh. TestGen-EQ's graphical interface enables instructors to view, edit, and add questions, transfer questions to tests, and print different forms of tests. Tests can be formatted by varying fonts and styles, margins, and headers and footers, as in any word-processing document. Search and sort features let the instructor quickly locate questions and arrange them in a preferred order. QuizMaster-EQ, working with your school's computer network, automatically grades the exams, stores the results on disk, and allows the instructor to view and print a variety of reports.

FASTFAX TESTING

FastFax Testing is designed for instructors who do not have access to a computer or an assistant who can help prepare tests for students. Simply choose from a large pool of questions in the print test bank and include custom headers, if you like. Fill out the test information sheet that lists instructor-selected questions and test preferences that describe how the test should be generated. You may even request multiple forms of a test and receive answer keys for each one.

Turnaround time is usually 48 hours or less and test pages can be mailed or faxed back to you by the date the test is needed. FastFax Testing is fast, reliable, and free to qualified adopters of this text.

ACKNOWLEDGMENTS

Working on a project such as this generates many debts that can never be repaid. But they can be acknowledged, and it is a special pleasure to be able to do so here and to express our heartfelt thanks to each and every one of the following long list, without whose contributions we could not have produced *Essential Foundations*.

Mark Rush is our Study Guide, Instructor's Manual, and Test Bank coordinator and manager. He assembled, polished, wrote, and rewrote these materials to ensure their close consistency with the text. He and we were in constant contact as all the elements of our text and package came together. Mark also made many valuable suggestions for improving the text and the Checkpoints. His contribution went well beyond that of a reviewer. And his effervescent sense of humor kept us all in good spirits along the way. Working closely with Mark, Tom Meyer, Neil Garston, and Tom Larson wrote content for the Study Guide and Carol Dole and Richard Gosselin wrote content for the Instructor's Manual. Seemi Ahmad, Ali Ataiifar, Sue Bartlett, Jack Chambless, Carol Dole, Paul Harris, Diego Mendez-Carbajo, William Mosher, Terry Sutton, Cindy Tori, and Nora Underwood provided questions for the Study Guide and Test Banks.

The ideas that ultimately became *Foundations* began to form over dinner at the Andover Inn in Andover, Massachusetts, with Denise Clinton and Sylvia Mallory. We gratefully acknowledge Sylvia's role not only at the birth of this project but also in managing the entire development team. Denise has been our ongoing inspiration for almost ten years. She is the most knowledgeable economics editor in the business, and we are privileged to have the benefit of her enormous experience.

The success of *Foundations* owes much to Victoria Richardson Warneck, our outstanding sponsoring editor. We are in awe of Victoria's extraordinary editorial craft. It has been, and we hope it will for many future editions remain, a joy to work with her.

Mary Clare McEwing has been our indomitable development editor, ably assisted by Dottie Dennis. We said in the preface to the first edition that Mary Clare had rounded up the best group of reviewers we'd ever worked with. We are astounded to report that for this edition, she has surpassed even the high standards she previously achieved. Mary Clare has steered the revision along through several redrafts and polishes. And she began the design process with focus groups that told us what teachers and students look for in the design of a textbook.

Gina Kolenda converted the raw ideas into this outstandingly designed text. Meredith Nightingale provided the detailed figure designs.

Jason Miranda did an incredible job as editor of our print supplements and coordinated the work of our large team of coauthors.

Michelle Neil, Executive Media Producer, and Melissa Honig, our technology gurus, have brought much to this project. Michelle spearheaded the effort to set up MyEconLab, worked creatively to improve our technology systems, and worked with our editors and us to develop our media strategy. Melissa built our Web site and worked tirelessly to help develop the engine that drives Foundations Interactive. They have both been sources of high energy, good sense, and level-headed advice, and have quickly found creative solutions to all our technology problems.

Nancy Fenton, our ever cheerful, never stressed production supervisor, ensured that all the elements eventually came together to bring our text out on schedule. Sally Simpson, our electronic publisher, and Laura Wiegleb, electronic production specialist, performed their magic to make our pages look beautiful. And Hugh Crawford oversaw the manufacturing process and worked with the printers and binders to produce beautiful, on-time books.

Our marketing manager, Adrienne D'Ambrosio, added enormous value, not only by being acutely intelligent and having a sensitive understanding of the market, but also by sharpening our vision of our text and package. As this book was in progress, Adrienne moved on to become an economics acquisitions editor and Stephen Frail joined us as marketing manager. Jit Teo and Catherine Bernstock stayed late many nights fielding requests from the sales force, and Kathy Kwack managed our online marketing efforts.

Our copy editor, Barbara Willette, and supplements copy editor, Sheryl Nelson, gave our work a thorough review and helpful polish.

Richard Parkin, our technical illustrator, created the figures in the text, the dynamic figures in the online version of the text, the illustrations in *Foundations Interactive*, and the animated versions of the figures in the PowerPoint presentations and contributed many ideas to improve the clarity of our illustrations. Laurel Davies created and edited the *Foundations Interactive* database and acted as its accuracy checker and reviewer.

Jeannie Gillmore, our personal assistant, worked closely with us in creating *Foundations Interactive* and the diagnostic Web quizzes and served as a meticulous accuracy checker on the text, Study Guide, and Instructor's Manual. John Graham of Rutgers University, Stephen McCafferty of Ohio State University, Harry Ellis of the University of North Texas, Paul Poast of Ohio State University, and Kate Krause of the University of New Mexico also provided careful accuracy reviews.

Jane McAndrew, economics librarian at the University of Western Ontario, went the extra mile on many occasions to help us track down the data and references we needed.

Finally, our reviewers, whose names appear on the following pages, have made an enormous contribution to this text. In the many texts that we've now written, we've never seen reviewing of the quality that we enjoyed on this project. It has been a pleasure (if at times a challenge) to respond constructively to their many excellent suggestions.

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Fernando Quijano, Dickinson State University

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Mary Rigdon, University of Texas, Austin

Helen Roberts, University of Illinois, Chicago

Barbara Ross-Pfeiffer, Kapiolani Community College

Jeffrey Rous, University of North Texas

Udayan Roy, Long Island University

Mark Rush, University of Florida

Joseph Santos, South Dakota State University

Roland Santos, Lakeland Community College

Ted Scheinman, Mount Hood Community College Jerry Schwartz, Broward Community College Sharmistha Self, College of St. Benedict/St. John's University Gautam Sethi, Bard College Martin Spechler, Indiana University John Stiver, University of Connecticut Terry Sutton, Southeast Missouri State University Vera Tabakova, Louisiana State University Donna Thompson, Brookdale Community College James Thorson, Southern Connecticut State University Marc Tomljanovich, Colgate University Cynthia Royal Tori, Valdosta State University Ngoc-Bich Tran, San Jacinto College South Nora Underwood, University of California, Davis Christian Weber, Seattle University Jack Wegman, Santa Rosa Junior College Jason White, Northwest Missouri State University Benjamin Widner, Colorado State University Barbara Wiens-Tuers, Pennsylvania State University, Altoona William Wood, James Madison University Ben Young, University of Missouri, Kansas City Michael Youngblood, Rock Valley College Joachim Zietz, Middle Tennessee State University Armand Zottola, Central Connecticut State University