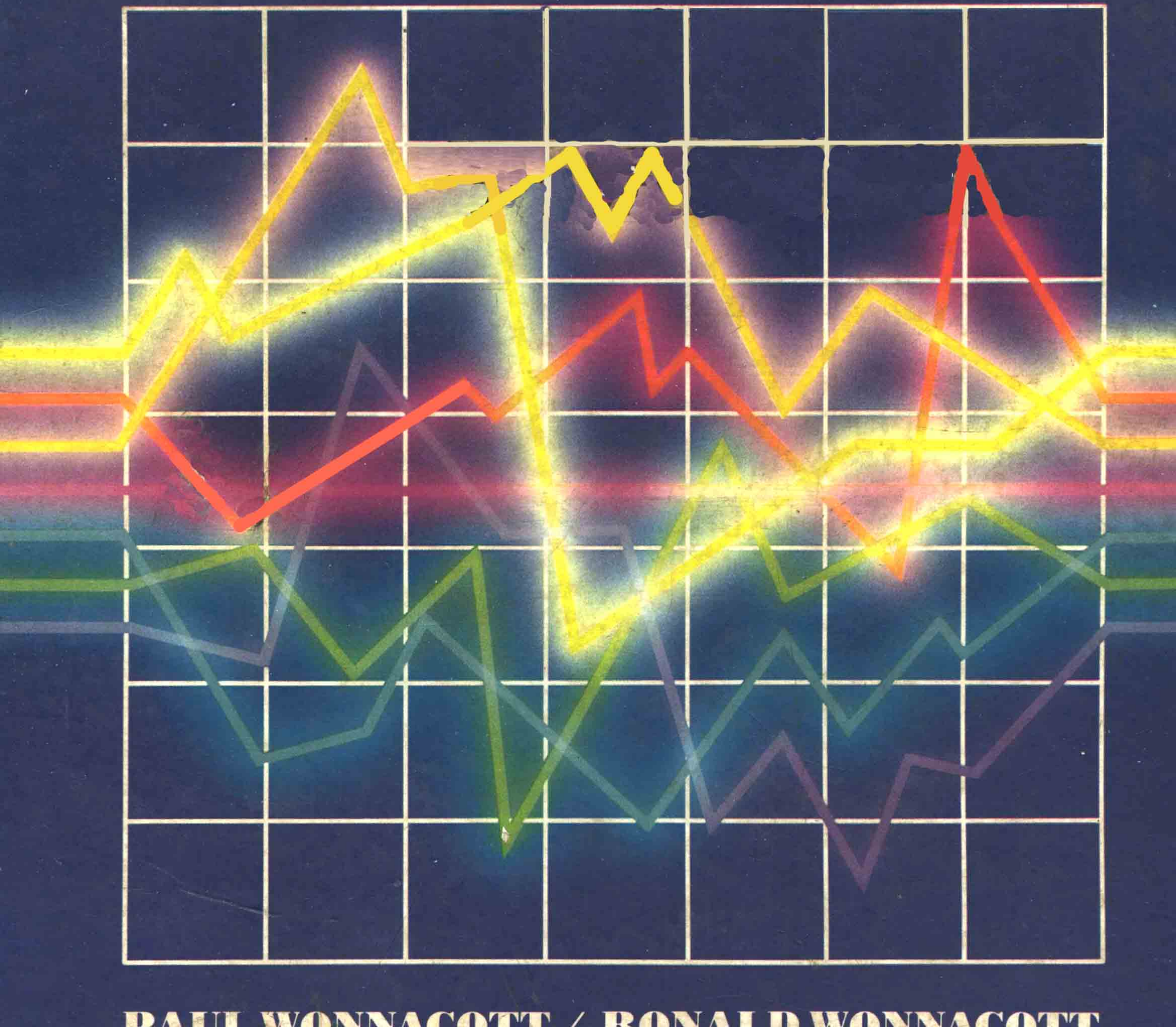
ECONOMICS



PAUL WONNACOTT / RONALD WONNACOTT

THIRD EDITION

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ECONOMICS

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SUGGESTED OUTLINE FOR A ONE-SEMESTER COURSE

Note: Boxes and Appendixes may be omitted in a one-semester course.

PART ONE: BASIC ECONOMIC CONCEPTS

1. Economic Problems and Economic Goals
2. Scarcity and Choice (to p. 33)
3. Specialization, Exchange, and Money
4. Demand and Supply: The Market Mechanism
6. Business Organization and Finance (section on business accounting only, pp. 102–105)

PART TWO: HIGH EMPLOYMENT AND A STABLE PRICE LEVEL

7. Measuring National Product and National Income (to p. 130)
9. *Explaining Unemployment and Inflation:* Aggregate Supply and Aggregate Demand
10. Equilibrium with Unemployment: The Keynesian Approach

PART THREE: AGGREGATE DEMAND POLICIES

11. Fiscal Policy (to p. 215)
12. Money and the Banking System
13. The Federal Reserve and Monetary Policy (to p. 255)

PART FOUR: GREAT MACROECONOMIC ISSUES OF OUR TIME

[Omit this part.]

PART FIVE: MICROECONOMICS: IS OUR OUTPUT PRODUCED EFFICIENTLY?

20. Demand and Supply: The Concept of Elasticity
21. Demand
22. *Costs and Perfectly Competitive Supply:* The Short Run
23. Costs and Perfectly Competitive Supply: The Long Run
24. Perfect Competition and Economic Efficiency (to p. 495)
25. Monopoly (to p. 521)
26. Markets between Monopoly and Perfect Competition

PART SIX: ECONOMIC EFFICIENCY: ISSUES OF OUR TIME

27. How Much Should the Government Regulate Business? (except pp. 561–569)
28. Protecting the Environment in a Growing Economy: How Should Pollution Be Limited? (to p. 583)
30. Public Goods: What Should the Government Provide? (to p. 623)

PART SEVEN: MICROECONOMICS: HOW INCOME IS DISTRIBUTED

33. *Wages in a Perfectly Competitive Economy*
34. Wages in Imperfectly Competitive Labor Markets
35. Other Incomes (to p. 734)

PREFACE

An understanding of economics has never been more important than it is today. Because of new technology, we produce many goods that were unheard of a few decades ago. And we produce old products in new ways. Changes in government policies have opened new opportunities for some, and have constrained others. Changes in economic conditions have created new and difficult problems.

This third edition of *Economics* represents a major revision and update. We have made every effort to present current material on the major policy issues of our time, while continuing to build a solid foundation of basic economic ideas.

THE CHALLENGE OF ECONOMICS

Economics is like the music of Mozart. On one level, it holds great simplicity: Its basic ideas can be quickly grasped by those who first encounter it. On the other hand, below the surface there are fascinating subtleties that remain a challenge—even to those who spend a lifetime in its study. We therefore hold out this promise: In this introductory study, you will learn a great deal about how the economy works—the basic principles governing economic life that must be recognized by those in government and business who make policy decisions. At the same time, we can also promise that you won't be able to master it all. You should be left with an appreciation of the difficult and challenging problems of economics that remain unsolved.

Perhaps some day you will contribute to their solution.

HOW TO USE THIS BOOK

Our objective has been to make the basic propositions of economics as easy as possible to grasp. As each new topic is encountered, essential definitions are printed in red type, and key steps in the argument are emphasized with boldface type. These highlights should be studied carefully during the first reading, and during later review. (A glossary is provided at the end of the book, containing a list of definitions of terms used in this text plus other common economics terms that you may encounter in class or in readings.) The basic ideas of each chapter are summarized in the Key Points at the end of the chapter, and new concepts introduced in the chapter are also listed.

When you read a chapter for the first time, concentrate on the main text. Don't worry about the boxes, which are optional. They are set aside from the text to keep the main text as simple and straightforward as possible. The boxes fall into two broad categories: *First* are the boxes that provide levity or color—for example, Kurt Vonnegut's tale in Box 36-2 of the Handicapper-General whose aim is to ensure that people will not only start out equal but also finish that way. *Second* are the boxes that present detailed theoretical explanations that are not needed to grasp the main ideas in the text. If you want to glance at the boxes that are fun and easy to read, fine. But when you first read a chapter, don't worry about those that contain more difficult material. On the first reading, you may also skip starred (*) sections of the text, along with the footnotes and appendixes; these also tend to be more difficult. Particularly challenging are the footnotes marked (*). Come back to them later, after you have mastered the basic ideas.

Economics is not a spectator sport. You cannot learn just from observation; you must work at it. When you have finished reading a chapter, work on the problems listed at the end; they are designed to reinforce your understanding of important concepts. [The starred (*) problems are either based on material in a box, or are more difficult questions designed to provide a challenge to students who want to do more advanced work.] Because each chapter builds on preceding ones, and because the solution to some of the problems depends on those that come before, remember this important rule: Don't fall behind in a problem-solving course. To help you keep up, we recommend the *Study Guide* (third edition) which is designed specially to assist you in working through each chapter. It should be available in your bookstore.

TO THE INSTRUCTOR

As we have revised and updated this text, we have continued to keep in mind the two major questions posed in the first edition. Our uneasiness regarding the answers provided a major reason for writing this book.

For macroeconomics, the principal question was this: After studying introductory economics, are students able to understand public controversies over such topics as the level of government spending and taxation, monetary policy, and the desirability of price controls? Are we training our students to understand the front pages of the newspaper? For many years, the introductory course was aimed at teaching students how policy should be run; that is, at providing a cookbook of "right" answers. While many books express more doubts and qualifications than was the case a decade ago, we have altered the focus of the course even more by building up to the six controversial questions in Part 4: Is fiscal or monetary policy the key to aggregate demand? Should the authorities attempt to "fine-tune" aggregate demand? How can inflation exist at the same time as a high rate of unemployment? How does the economy adjust to inflation, and what complications does inflation present to the policymaker? Why have productivity and growth been disappointing since 1973? Should exchange rates be fixed or flexible?

While there are no simple, indisputably "correct" answers to these questions, we believe that the major issues can be presented clearly to beginning economics students, thereby providing them with an understanding of important, recurring public debates over macroeconomic policy.

For microeconomics, the question was this: Does the introductory study of microeconomics lack coherence? To the student, does microeconomics tend to become just one thing after another—a guided tour through the economist's workshop, introducing as many polished pieces of analytic machinery as possible for later use in more advanced courses? Most students do not continue to advanced economics courses. For them, there is little point in concentrating on analytic techiques for their own sake, when time could be spent studying interesting policy issues instead. Even for those who do continue in economics, we doubt that it is useful to focus so heavily on analytic techniques. True, such a focus gives students some headstart in their later courses; but it also increases the risk that they will be bored by repetition, and will miss some of the forest while concentrating on the trees. Therefore, we follow a simple rule of thumb: In introducing analytic concepts, we focus on those most useful in studying policy issues.

In the third edition, as in the first two, we have attempted to make microeconomics more interesting by organizing our discussion around two continuing themes: ***efficiency*** and ***equity.*** Efficiency is the focus of attention in Parts 5 and 6, and equity in Part 7.

Major Revisions

Like the world of high technology, the world of economics is changing rapidly. Huge pools of internationally mobile capital have led to fluctuations in currency values and third-world debt problems far beyond our experience of just a few years ago. The United States seems committed to spending and taxation policies which imply large budget deficits as far as the eye can see. Even after adjustment for inflation and the size of the economy, these deficits are unprecedented, except for wartime periods.

In these circumstances, professors may expect substantial updating of any economics text. We have responded by revising every chapter to some degree; in most cases, the revisions have been substantial. Here are some of the main changes.

In the *macroeconomic sections* of the book—Parts 2 through 4—two new chapters have been added. Chapter 8, "Fluctuations in Economic Activity: Unemployment and Inflation," reviews the major developments and problems in the U.S. economy. Two points are emphasized. (1) We have been successful in preventing a repeat of the Great Depression. Our greater understanding of macroeconomics has had a payoff in terms of better policies. (2) However, cycles have not been getting milder and milder; the recessions of 1973–1975 and 1981–1982 were more severe than those of the fifties and sixties. Macroeconomics is not a simple subject, with simple solutions to our problems. This theme provides the background for the later study of major unsettled questions in macroeconomics (Part 4).

Chapter 9, "Explaining Unemployment and Inflation: Aggregate Supply and Aggregate Demand," is designed to give students a broad overview before the detailed study of macroeconomics. In introducing the concepts of aggregate supply and aggregate demand, we have taken care to explain why we cannot simply assume that the aggregate curves slope the same way as the curves for an individual product. When drawing a demand or supply curve for an individual product—such as hamburgers or shoes—we consider the responses of buyers and sellers to changes in relative prices; they respond by switching to (or from) other products. For aggregate demand and aggregate supply, there is no such switching, because we are dealing with the overall price level, not changes in relative prices. Chapter 9 also provides an introduction to the differences between the Keynesian and classical schools. Although there are many points of agreement among macroeconomists, substantial areas of disagreement remain.

In the macroeconomic chapters, other changes include the following:

1. Much more attention is now paid to budget deficits and the growing national debt. There are major new sections on these topics in the chapter on fiscal policy (Chapter 11), and in the chapter on the relative importance of fiscal and monetary policies (Chapter 14). In this latter chapter, the new edition includes a discussion of the relationship between government deficits, interest rates, exchange rates, and trade deficits. At the same time, some dated topics have been dropped. For example, in a period when the government is having great difficulty in gaining control of the budget, it no longer seems necessary to have a section on fiscal drag.

2. The discussion of growth and productivity in Chapter 18 has been extensively rewritten and updated, with a major change in emphasis. No longer is the question simply one of why growth and productivity were disappointing in the 1970s. The new chapter also includes a discussion of growth and productivity in the early 1980s, and explores whether we are solving our productivity problems. We do not offer a categorical answer; sufficient information is not yet available. (There is an important relationship between productivity and the business cycle, and the strong cycle of the early 1980s has made it difficult to identify underlying trends in productivity.) This chapter includes a discussion of the supply-side strategy of the Reagan administration.

In the *microeconomic chapters,* major organizational changes have been made. The chapter on "Costs and Perfectly Competitive Supply" has been divided into two chapters; one describes the short run, and the other describes the long run . This division should provide students with more breathing space in the development of the basic microeconomic theory. Equally important has been the reorganization of the micro chapters into three broad groupings: the basic theory of product markets in a new Part 5, followed by a new Part 6 entitled "Economic Efficiency: Issues of Our Time," and finally, Part 7 on factor markets and the distribution of income.

The creation of new Part 6 offers several advantages. First, it highlights the policy issues in microeconomics, just as Part 4, "Great Macroeconomic Issues of Our Time," deals with the important macro policy questions. Second, it improves the flow of the book. The chapter on resources has been fully reworked so that it can be moved forward into this new Part 6, where it is linked to the chapter on pollution. Just as pollution imposes an external cost on those downstream or downwind, so too the extraction of a common property resource creates an external cost—in this case the cost to future generations who are left with less of the resource.

In response to changing conditions and suggestions of reviewers, the discussion of energy has been reduced in size, and is now included in the resource chapter (Chapter 29). While energy is still an important topic—OPEC is still used as an example of the opportunities and problems facing collusive oligopolists in Chapter 26—there is a shift in emphasis away from oil as a crisis commodity to oil as a vivid historical example of the complications that arise when the government controls a price. Finally, moving resources and energy forward into Part 6 improves the flow of Part 7 on income distribution. The chapter on the way in which markets distribute income is followed immediately by the controversies over how income *should* be distributed, and over the policies that the government can use to alter income patterns.

New material in microeconomics includes an expanded discussion of transactions and time costs in the chapter on demand (Chapter 21); a new section on contestable markets in the chapter on imperfect competition (Chapter 26); an updated description of the farm programs and their increasing costs in the 1980s; material on the rising rate of poverty; and sections on the breakup of AT&T and the new wave of giant mergers—including a description of greenmail, white knights, pac-man strategies, and other forms of shark repellant.

Looking Ahead

Because we have attempted to build the discussion in orderly steps, we recommend that teachers look ahead to later passages before introducing certain subjects. For example, before teaching the basics of microeconomics in Part 5, we suggest that teachers glance ahead to the most important initial building blocks—the highlighted "Essential Ideas for Future Chapters" in Chapters 20 to 23, and the first 10 pages of Chapter 24 where the concept of efficiency is explained in detail. Similarly, we recommend that instructors who wish to teach indifference curves not only read the first indifference curve appendix (in Chapter 21), but also look ahead to the second (in Chapter 24). In the second appendix, we consider a topic not found frequently in elementary texts; namely, how indifference curves can be used to illustrate the way in which a perfectly competitive economy results in an efficient allocation of resources. Students find this an interesting topic. And this use of indifference curves fits directly into our emphasis on efficiency throughout Parts 5 and 6 of this book.

Other Points of Interest

Finally, we draw your attention to a number of ways in which our treatment differs from that of many other economics texts.

- In emphasizing efficiency and the gains from specialization, we have given greater attention to economies of scale than is frequently the case. In Chapters 3 and 31, economies of scale are given billing almost equal to comparative advantage. In our opinion, economies of scale are an important source of gain from specialization, and they should not be avoided because of the difficult analytic problems to which they lead. Most of the analytic problems can be avoided in an introductory text.
- We consider the problem of financial instability in more detail than most other books. (For example, see the discussion of the instabilities of the monetary system during the Great Depression in Chapter 13, and the overview of financial instability in recent recessions in Box 13-2.) In our opinion, the Keynesian revolution resulted in too little attention to the financial side of the economy.
- We discuss the gold standard—and the problems which it raises—in more detail than most other books (pages 260 to 264). This topic is important for an understanding of history, particularly the problem of bank instability. Many students are fascinated by the gold standard. Like most economists, we believe that it would be a mistake to go back to the gold standard—particularly in its classical version, with the quantity of money determined by the quantity of gold. But we also believe it is important that students of economics know *why*.
- Because of our emphasis on major themes and problems, our discussion of international economics is organized differently from that in most books. The gains from trade and the effects of protection fit into the topic of efficiency, and therefore they are included in the microeconomic part of the book, in Chapters 31 and 32. But exchange rate arrangements are most closely related to such issues as inflation and unemployment, and they are therefore included with other macroeconomic topics, in Chapter 19. By keeping international topics next to the related domestic topics, we hope to counteract the neglect of international economics in many introductory courses.
- Students are introduced to the important idea of dynamic efficiency. Any detailed analysis of dynamic efficiency has traditionally been regarded as too difficult for an elementary course. Initially we sympathized with this view, until we discovered that most beginning students *can* handle a problem like the most efficient pattern of resource use over time (optional Box 29-3).
- We show how conflicts can exist not only between objectives such as equity and efficiency, but also between groups of people in the economy. For example, the theory of comparative advantage illustrates how foreign trade can increase a nation's real income. We go one step further, to emphasize how trade affects various

groups differently: Low-cost imports benefit consumers, but they hurt competing domestic producers. It is easy for students to identify such winners and losers. They thereby can appreciate the irony of complaints about agricultural price supports from business executives who benefit from tariffs that prop up the prices of the goods *they* produce. Moreover, this identification of different groups—and the differences in their political power—helps the student to answer one of the basic questions raised by the theory of public choice: Why is there a difference between what the government *should* do and what it *does* do?

- Other topics on which we have placed more-than-usual emphasis include externalities (Chapters 28 to 30) and the difficulty of policymaking when we face both a high rate of unemployment and high inflation (Chapter 16).

Alternative Course Designs

As already noted, some of the boxes in the text are used to introduce material that may be too difficult for some students, but highly enlightening for others. (See, for example, Box 24-2 on Pareto efficiency and Box 25-1 on the theory of the second best.) We hope that these boxes, along with similarly designed appendixes, will give you flexibility in designing your course.

In a further attempt to provide flexibility, we have brought all the macro chapters together into Parts 2 to 4, and all the micro chapters together into Parts 5 to 7. The majority of instructors who teach macro first can use the chapters in the order in which they appear in the book. Those who wish to teach micro first can cover Parts 1, 5, 6, 7, 2, 3, and 4, in that order. For instructors teaching a one-semester course, there are two paperback options: *An Introduction to Macroeconomics,* and *An Introduction to Microeconomics*. Those who wish to cover both macro and micro quickly in one semester should consult the Suggested Outline, preceding this Preface. To those who are teaching such a one-semester survey course, we would like to pass on a suggestion from veterans: Don't try to cover too much. A full year's work is simply too much for students to digest in one semester.

WE WISH TO THANK . . .

In developing this third edition, we have shamelessly accumulated intellectual debts to our colleagues and coworkers. We should like to thank our editor, Alison Meersschaert, for her insistence that every sentence be comprehensible to the undergraduate, and Michael Hartman, whose comprehensive review of the second edition provided a starting point for our revisions. We are particularly indebted to teachers of economics who have advised us or reviewed the text in its various drafts, and have provided a wealth of suggestions. These contributors—to this third edition as well as to earlier editions—are acknowledged on the following pages. To all, we express our sincere thanks.

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CONTENTS

PART THREE
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