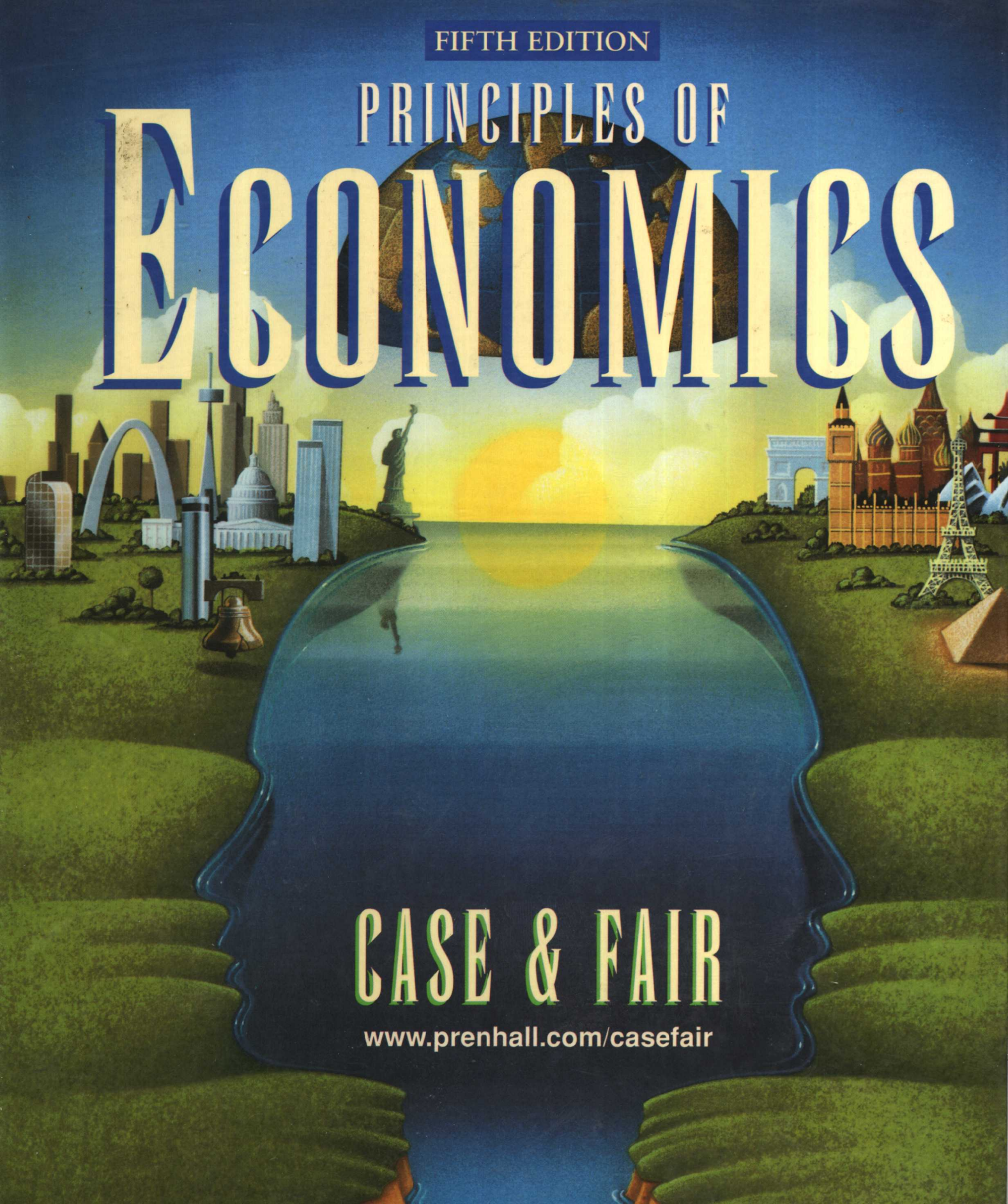


FIFTH EDITION

PRINCIPLES OF ECONOMICS



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FIFTH EDITION

PRINCIPLES OF ECONOMICS

Karl E. Case

WELLESLEY COLLEGE

Ray C. Fair

YALE UNIVERSITY



Prentice Hall, Upper Saddle River, New Jersey 07458

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To
Professor Richard A. Musgrave
and
Professor Robert M. Solow

PREFACE

AS THIS FIFTH edition is being prepared to go on press, we are into the 28th consecutive quarter of expansion in the U.S. economy. Unemployment is at its lowest in nearly 30 years. A number of Asian economies, including Korea, Thailand, and Indonesia, have suffered sharp economic downturns, and even Japan, the world's second largest economy, is suffering through recession and slow growth. Much of Europe is set to adopt a common currency. Hong Kong has become part of China. Congress passed the Taxpayer Relief Act and welfare reform has become reality. The Russian economy has begun to grow. (When our first edition was published in 1989, the Berlin Wall had not yet fallen, the Cold War still chilled international relations, and Iraq had not yet invaded Kuwait.) How rapidly the world is changing!

The degree to which the economic landscape has changed since our fourth edition was published has led to hundreds of changes—some large, some not so large, some you might expect, some not—in this revision. One way of reflecting many of those changes in the landscape is through the new Fast Facts feature we added to every chapter. Each Fast Fact contains some additional data or current example that describes a significant change in the economy. This feature adds depth to the text but does not add bulk, because each Fast Fact is concise and most are written to fit in the margin column.

Revising a book involves adding new material, and there is a tendency for textbooks to grow in volume over time. However, student time is a scarce resource, and longer books are more costly to produce. Therefore, our goal throughout was to update, refine, and add material where needed, but to end up cutting excess baggage and obsolete material wherever possible. The bottom line is that the fifth edition is a shorter book.

All tables and figures have been updated with the most recent data available, and the case studies that end each part are completely new. Although we continue to cover the core of economic theory, we have added new material on important topics that have only recently emerged as major economic issues. These include health-care reform, immigration, urban problems and crime, the balanced budget amendment, welfare reform, the new trade treaties, several countries' recent problems with volatile exchange rates, and the experiences of transitional economies.

In addition, the fifth edition contains more international material than any previous edition. Almost every

chapter contains a global application or example. A complete list of global examples follows the detailed table of contents. We've also added many new problems to the end of each chapter and included solutions to the even-numbered problems at the end of the text.

To date, more than 400,000 students and professors have used *Principles of Economics* or one of its split volumes. In this new edition, we have made every effort to be responsive to our readers' suggestions while maintaining the book's basic focus and pedagogical organization. To make the book accessible to a wider range of students, we have cut a great deal of extraneous material, simplified several of the more analytical sections, and redrawn many of the more technical graphs using numbers rather than variable names. Also, to make the book more appealing to today's visual learners, we've completely revised the art, photo, and illustration program. The result, we hope, is a principles book that students will keep on their shelves and use throughout college and beyond.

THE PLAN OF THE FIFTH EDITION

Despite major revisions and new features, the themes of the fifth edition are the same themes of the first four editions. The purpose of this book is to introduce the discipline of economics and to provide a basic understanding of how economies function. This requires a blend of economic theory, institutional material, and real-world applications. We have tried to maintain a reasonable balance between these ingredients in every chapter in this book. Like the first four editions, the fifth edition also attempts to present differing theoretical views in an evenhanded way.

Although we have chosen to present microeconomics first, we have designed the text so that professors may proceed directly to macroeconomics after teaching the five introductory chapters.

MICROECONOMICS

Market research and comments from users of the third edition convinced us that the organization of the microeconomic material is pedagogically sound. For this reason, we have not altered the presentation drastically.

The organization of the microeconomic material continues to reflect our belief that the best way to understand

how market economies operate—and the best way to understand basic economic theory—is to work through the perfectly competitive model first, including discussions of output *and* input markets and the connections between them, before turning to noncompetitive market structures. When students understand how a simple competitive system works, they can start thinking about how the pieces of the economy “fit together.” We think this is a better approach to teaching economics than some of the more traditional approaches, which encourage students to think of economics as a series of disconnected alternative market models.

Doing competition first also allows students to see the power of the market system. It is impossible to discuss the things that markets do well until students have seen how a simple system determines the allocation of resources. This is our purpose in chapters 6–11. Chapter 12 remains a pivotal chapter that links the world of perfect competition with the imperfect world of noncompetitive markets, externalities, imperfect information, and poverty, all of which we discuss in chapters 13–17. In chapters 18–20, students use everything they’ve learned in chapters 6–17 to take a closer look at some of the fields of applied microeconomics (the economics of taxation, labor economics, and the economics of health care, immigration, and the urban problems).

MACROECONOMICS

Several new textbooks have shifted the emphasis in the presentation of macroeconomics from short-run income determination to long-run growth while de-emphasizing business cycles, the role of countercyclical policy, and the problems of unemployment and inflation. Although we agree that growth deserves more attention in macroeconomics, we have chosen *not* to follow their lead. We remain convinced that the basic structure of aggregate supply and aggregate demand provides a very powerful pedagogical framework within which students can come to understand the nature of the debates that now permeate the professional literature, including the efficacy of monetary and fiscal policy, the role of the Fed, and the factors that determine growth and the cyclical behavior of the economy. We are also convinced that unemployment and inflation remain serious potential problems for economies in the United States and across the world.

Although we have made a number of changes to the content of the macroeconomic material, we remain committed to the view that it is a mistake simply to throw aggregate demand and aggregate supply curves at students in the first few chapters of a principles book. To understand the *AS* and *AD* curves, they need to know about the

functioning of the goods market and the money market. The logic behind the simple demand curve is simply wrong when applied to the relationship between aggregate demand and the price level. Similarly, the logic behind the simple supply curve is wrong when applied to the relationship between aggregate supply and the price level.

Part of teaching economics is teaching economic reasoning. Our discipline is built around deductive logic. Once we teach students a pattern of logic, we want and expect them to apply it to new circumstances. When they apply the logic of a simple demand curve or simple supply curve to the aggregate demand or aggregate supply curve, the logic does not fit. We believe the best way to teach the reasoning embodied in the aggregate demand and aggregate supply curves without creating serious confusion is to build up to them carefully.

Organization As in the fourth edition, the macroeconomics section begins with three introductory chapters (21–23) that introduce students to macroeconomic tools, national income accounting, and inflation and unemployment (both in the United States and abroad). These chapters are followed by two chapters that present the basic functioning of the goods market (chapters 24 and 25) and two chapters that present the basic functioning of the money market (chapters 26 and 27). It is these four chapters that students are introduced to the concepts of fiscal and monetary policy. These chapters are followed by a chapter that brings the two markets together. This chapter, chapter 28, does in essence a very simplified version of *IS/LM* analysis verbally. (The *IS* and *LM* curves are included in an appendix to chapter 28 for those instructors who are interested in teaching them.)

Given the groundwork that has been laid in chapter 28, chapter 29 proceeds directly to derive the aggregate demand curve and then the aggregate supply curve. The two curves are then put together to determine the aggregate price level and to discuss the various theories of inflation.

Following the development of the *AD* and *AS* curves, we turn to a more detailed look at the labor market in chapter 30 and discuss various theories of unemployment. By the end of chapter 30, students have put the goods market, the money market, and the labor market together, and they have analyzed inflation, unemployment, and monetary and fiscal policy. Chapter 31 uses the material learned earlier to analyze a number of current macroeconomic issues, including proposed balanced-budget legislation and business cycles in Europe and Asia.

In chapter 32, we take a closer look at the behavior of households and firms in the macroeconomy. It can be

skipped without losing the flow of the material. We close the macro section of the book by looking at some current debates in macroeconomics (chapter 33) and economic growth and productivity (chapter 34).

Content In preparing the fifth edition, we have maintained the two innovations we introduced in the second edition. The first of these is the treatment of aggregate supply. Clearly, there is strong disagreement among economists and across economics textbooks on the exact nature of the aggregate supply curve. All economists agree that if input prices rise at the same rate as output prices, the aggregate supply curve is vertical; firms have no incentive to change output if their costs and revenues change at the same rate. For the AS curve to have a positive slope in the short run, input prices must either be constant or there must be some lag in their adjustment.

Some textbooks assume that input prices are constant when the overall price level changes, essentially treating the aggregate supply curve as if it were the sum of individual market supply curves. This assumption of constant input prices is obviously unrealistic, and in the second edition we changed our description of the short-run AS curve to one that assumes some lag in input price adjustment when the overall price level changes. In addition, we clarified and expanded our description of the long-run aggregate supply curve, incorporating the concept of potential GDP.

Second, we continue to distinguish between inflation (a change in the overall price level) and *sustained* inflation (an increase in the overall price level that continues for some period of time). There can be confusion in students' minds as to what inflation is and whether or not it is a purely monetary phenomenon, and we think that this distinction helps to clarify our discussions.

HIGHLIGHTS OF THE FIFTH EDITION

NEW FAST FACTS IN EVERY CHAPTER

An important new feature of the fifth edition is that several Fast Facts have been added to every chapter. Each is either a new table of data, an additional example, a research result, or simply an illustration of a point made in the text. Although brief and not as involved as a box, we believe these will add depth and richness to the material. As an example, in the discussion of elasticity, we obtained some current estimates of price elasticity of demand for a number of common goods from Regional Financial Associates, a first-rate forecasting and modelling firm in Philadelphia.

Other examples include a brief discussion of the Three Gorges Dam under construction in China, the current U.S.-dollar exchange rates against several currencies, and a table showing the cumulative effects of alternative growth rates over 10- and 20-year time periods.

RECENT DATA, EXAMPLES, EVENTS, AND TOPICS

Every chart, table, and graph in the book has been revised with the most recent data available. In addition, we have integrated topics that have generated a great deal of attention over the last few years—the economics of crime, immigration and health care, the Justice Department's assault on Microsoft, the recent experiences of Russia and the economies of Eastern Europe, the continuing economic problems of Asia, the adoption of a common currency in Europe, the debate about shifting to a consumption tax, and the decline of the "natural monopolies" and consequent deregulation of electricity rates, to name just a few.

THE BEA'S NEW PROCEDURE

The Bureau of Economic Analysis (BEA) make a major change at the end of 1995 in its presentation of the national income and product accounts. The focus is no longer on constant-dollar magnitudes and on implicit price deflators, but instead on "chain-type annual weights" quantity and price indexes. This change is much more important than the BEA's change in focus a few years ago from GNP to GDP.

Unfortunately, our enthusiasm to get the description of the new and complex chain index into the fourth edition led us to pitch the discussion too high. We heard from many students and instructors that the presentation was too hard. Therefore, we have completely rewritten that section and lowered the level of the discussion. The topic remains a difficult one for students to understand, however, and some may wish to skip it altogether.

INCREASED COVERAGE OF INTERNATIONAL MATERIAL

We have increased our coverage of international material in three ways. First, we have added many new Global Perspective boxes throughout the text. These boxes are designed to illustrate economic logic with global examples and to emphasize today's global economy. Second, we introduce imports and exports into the simple goods market model early in macroeconomics. (We do, however, continue to believe that a complete treatment of open market macroeconomics should not be taught until students have mastered the logic of a simple closed macroeconomy. For this reason, we have chosen to place the "open-economy

macro" chapter in International Economics, the final section of the book.) Finally, we have integrated international examples directly into the text whenever appropriate. All international examples are listed in a table following the book's detailed table of contents.

OPTIONAL CHAPTERS

We have tried to keep uppermost in our minds that time is always tight in a principles course. For this reason, we have made sure that certain chapters can be skipped without losing the flow of the material. In microeconomics, chapter 11 (on the capital market) can be skipped because chapter 10 (on input markets in general) covers the basics of the capital market. Similarly, the "topics" chapters in Part Four can be skipped if time is short.

In macroeconomics, chapters 32–34 are optional. The chapters in the international section, with the exception of chapter 36, can be taught at any time that the instructor deems appropriate.

STUDENT LEARNING AIDS

Each chapter begins with a brief overview of what the student has learned in the previous chapter and ends with a brief "look ahead" to the following chapter. To help students study, key terms have been printed in boldface and glossed to the margins. Each chapter ends with a point-by-point summary of the chapter, a list of review terms and concepts (cross-referenced to text page), and a problem set.

Because many believe that economics must be relevant to be interesting, we have included three types of boxes for the fifth edition. Global Perspective boxes provide economic examples from around the world. Application boxes apply the theory learned in the text to real-world events and situations. Issues and Debates boxes examine many of the economic issues currently under debate.

In addition, we have set the major principles of economics off from the text in such a way as to highlight their importance. These highlights flow logically from the preceding text and into the text that follows. Students tell us that they find these very useful as a way of reviewing the key points in each chapter to prepare for exams.

PROBLEM SETS AND SOLUTIONS

Each chapter and appendix ends with a problem set that asks students to think about what they've learned in the chapter. These problems are not simple memorization questions. Rather, they ask students to perform graphical analysis or to apply economics to a real-world situation or policy decision. Approximately 40 percent of the problems are new to this edition. More challenging problems are

indicated by an asterisk. The solutions to all even-numbered problems appear at the back of the book. The solutions to all odd-numbered problems, as well as additional problem sets, are available in the Instructor's Resource Manual.

CASE STUDIES

The end-of-part case studies continue to be quite popular. The fifth edition features nine new case studies on topics ranging from the spotted owl and new homes to making your own money.

Each case study is accompanied by questions for analytical thinking. The cases are not simply additional problems, and they are not simple extensions of the text material. They are meant to be applications of some of the *ideas* that the part was designed to teach and are designed to foster critical thinking and "thinking like an economist." They might be used as assignments or for class discussion.

TEACHING AND LEARNING TOOLS

The ancillary package for the fifth edition reflects changes in technology and utilizes new ways of disseminating information. A customized Web site links with Prentice Hall Learning on the Internet Partnership (PHLIP) to offer a comprehensive Internet package for the student and the instructor. An integrated package of software, printed supplements, videos, and reference guides completes the total teaching and learning package. Please contact your Prentice Hall sales representative for information on any of the Case and Fair supplements.

INTERNET RESOURCES (WWW.PRENHALL.COM/CASEFAIR)

The Case and Fair Web site offers students another opportunity to sharpen their problem-solving skills and to assess their understanding of the text material. Just go to the Case and Fair site and click on the Online Study Guide for additional true/false, multiple-choice, fill-in-the-blanks, and essay questions. The site also connects the student to the Take It to the Net web-destination exercises cited at the end of each chapter in the text. The online study guide has a built-in grading feature; students take the exams and receive immediate feedback.

From the Case and Fair Web site, the student and the instructor can link to PHLIP. Developed by Dan Cooper at Marist College, PHLIP provides academic support for faculty and students using the fifth edition. The student section of PHLIP offers some downloadable supplements as well as PHLIPing through the News, a review of current-events articles keyed to topics in the text. Scott Simkins (North Carolina A&T State University) and Jim Barbour (Elon

College) update the articles biweekly and provide summaries with discussion questions and research ideas. The faculty section of PHLIP requires a user name and password—please contact your Prentice Hall sales representative.

ECONOMICS EXPLORER RUNTIME MULTIMEDIA

The *Economics Explorer* CD-ROM, developed by Prentice Hall and Logal Software, Inc., combines video, animation, and spreadsheet capabilities to bring economics to life. Logal has taken the basic economic models from the textbook and created a series of dynamic, interactive simulations that help students visualize how math, graphs, and economic intuition are connected.

Once students have learned to use the simulation, they can design their own experiments and test their own conjectures. Using *Economics Explorer*, students can test the limits of economic models, input their own data to recreate events from economic history, and (using spreadsheet capabilities) record the results and display them in graphs like those from their textbook.

The fifth edition Instructor's Manual provides tips for integrating *Economics Explorer* into the course. The Study Guide alerts the students to relevant exercises tied to topics in the text.

STUDY GUIDES

Two comprehensive study guides, one for microeconomics and one for macroeconomics, have been prepared by Thomas Beveridge of North Carolina State University. These study aids reinforce the textbook and provide students with additional applications and exercises. Each chapter contains the following elements:

- **Point-by-Point Objectives.** A list of learning goals for the chapter, along with a brief summary of the material, helpful study hints, practice questions with solutions, and page references to the text.
- **Practice Tests.** Approximately 20 multiple-choice questions and their answers.
- **Application Questions.** A series of multiple-choice questions that require the use of graphic or numerical analysis to solve economic problems.
- **Solutions.** Worked-out solutions to all questions in the Study Guide, complete with page references to the text.
- **Comprehensive Part Exams.** Nine part exams to test the students' overall comprehension consisting of up to 25 multiple-choice questions, extended examples, and problem questions where appropriate.

The study Guide also references the Take It to the Net Web exercises from the text and alerts the student to relevant applications in the *Economics Explorer* software.

INSTRUCTOR'S MANUALS

Two innovative instructor's manuals, *Principles of Microeconomics* and *Principles of Macroeconomics*, were written by Mary Lesser at Iona College. The manuals are designed to help the instructor incorporate applicable elements of the fifth edition supplement package. The manuals include:

- Detailed chapter outlines with key terminology, teaching notes, and lecture suggestions.
- Video Guide for the 1998/99 Economics Video Library.
- Class Tips from Students, which feature real-world ideas from the students' point of view.
- Teaching Tips on incorporating the Take It to the Net Web exercises and *Economics Explorer* software.
- Additional Problems with solutions.
- Extended Applications, which include exercises, activities, and experiments to help make economics relevant to students.
- Solutions to all odd-numbered problems from the text.
- Case Study Solutions for the analytical thinking questions that accompany cases from the fifth edition text.

TEST ITEM FILES

The fifth edition test bank, completely revised and updated by Timothy Duy of the University of Oregon, contains almost 7,000 true/false, multiple-choice, short-answer, and essay questions. Also included are Problem Sets, a series of questions based on a scenario or graph. Each question in the test bank is page-referenced and coded for level of difficulty (easy, moderate, challenging, and honors). Questions are also classified as fact, definition, single, and multi. Questions classified as single require the student to use a single-step analytical process to answer, whereas the questions classified as multi require the student to perform numerous steps in the analytical process.

A test item file is available for both microeconomics and macroeconomics, in printed form or in a computerized version.

PH CUSTOM TESTS

Available for Windows and Macintosh, PH Custom is the computerized version of the test item files. The test program allows professors to edit, add or delete questions from the test item file, edit existing graphics and create new graphics, and export files to word processing programs.

POWERPOINT LECTURE PRESENTATION

An all-new PowerPoint presentation, by Mark Karscig of Central Missouri State University, offers summaries and necessary reinforcement of important text material. Many important graphs “build” over a sequencing of slides so that students may see the step-by-step process involved in economic analysis. The package will allow for instructors to make full-color, professional-looking presentations while providing the ability for custom handouts to be provided to the students.

COLOR TRANSPARENCIES

All figures and tables from the text are reproduced as full-page, four-color acetates.

ABC NEWS/PRENTICE HALL VIDEO LIBRARY

ABCNEWS

ABC News and Prentice Hall combine their individual expertise in academic publishing and global reporting to provide a comprehensive video ancillary to the fifth edition. The 1998/99 Economics Video Library contains 23 news clips from *Nightline*, *World News Tonight*, *Wall Street Journal Report*, and *20/20*. Each clip illustrates the vital, ongoing connections between what is learned in the classroom and what is happening in the world around us. All the videos are timely or timeless, and many can be used at different points in the course. The instructor's manuals provide suggestions on where and how to integrate each video.

THE NEW YORK TIMES “THEMES OF THE TIMES”

The New York Times, Inc., and Prentice Hall collaborate to offer *Economic Themes of the Times*—12 newspaper pages full of current articles on public policy, business, finance and other issues that expose the real-world, everyday relevance of economics. “*Themes of the Times*” is available for both Spring and Fall quarters.

The New York Times offers a reduced subscription rate for students and professors. For more information, call 1-800-631-1222.

SURFING FOR SUCCESS INTERNET GUIDE

Surfing for Success in Economics 1998/99 is an invaluable guide on using Internet resources. Scott Simkins and Jim Barbour join Andrew Stull in creating a reference that not only helps beginning students learn their way around the

Internet, but lists economics-related sites and Your Turn Web-destination exercises to make surfing the Internet a natural part of the economics classroom.

THE SECOND YEAR SUPPLEMENT PACKAGE

A new wave of supplements will be available to help the instructor in the second year of using the fifth edition textbook:

- A brand new Test Item File, written by Mary Lesser, Iona College.
- 1999/2000 Economics Video Library and Video Guide.
- Presentation Manager.

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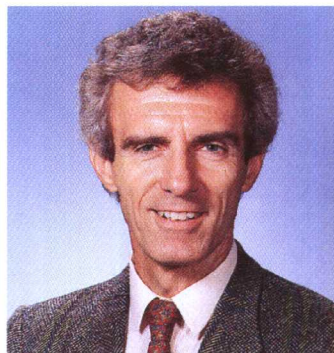
Karl E. Case

is the Marion Butler McLean Professor in the History of Ideas and Professor of Economics at Wellesley College. He also lectures on economics and tax policy in the International Tax Program at Harvard Law School and is a visiting scholar at the Federal Reserve Bank of

Boston. He received his B.A. from Miami University in 1968, spent 3 years in the army, and received his M.A. and Ph.D. from Harvard University. In 1980 and 1981, he was Fellow in Law and Economics at Harvard Law School.

Professor Case's research has been in the areas of public finance, taxation, and housing. He is the author or coauthor of four other books, including *Economics and Tax Policy* and *Property Taxation: The Need for Reform*, as well as numerous articles in professional journals.

For the past 21 years, he has taught at Wellesley College. Before coming to Wellesley, he served as Head Tutor (director of undergraduate studies) at Harvard, where he won the Allyn Young Teaching Prize. He has been a member of the AEA's Committee on Economic Education and was Associate Editor of the *Journal of Economic Education*, responsible for the section on innovations in teaching. He teaches at least one section of the principles course every year.



Ray C. Fair

is Professor of Economics at Yale University. He is a member of the Cowles Foundation at Yale and a Fellow of the Econometric Society. He received a B.A. in economics from Fresno State College in 1964 and a Ph.D. in economics from M.I.T. in 1968. He taught at Princeton University

from 1968 to 1974 and has been at Yale since 1974.

Professor Fair's research has primarily been in the areas of macroeconomics and econometrics, with particular emphasis on macroeconometric model building. His publications include *Specification, Estimation, and Analysis of Macroeconometric Models* (Harvard Press, 1984) and *Testing Macroeconometric Models* (Harvard Press, 1994).

Professor Fair has taught introductory and intermediate economics at Yale. He has also taught graduate courses in macroeconomic theory and macroeconometrics.

Professor Fair's United States and multicountry models are available for use on the Internet free of charge. The address is <http://fairmodel.econ.yale.edu>. Many teachers have found that having students work with the United States model on the Internet is a useful complement to even an introductory macroeconomics course.

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house keeper 女管家
~ wife 家庭妇女

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