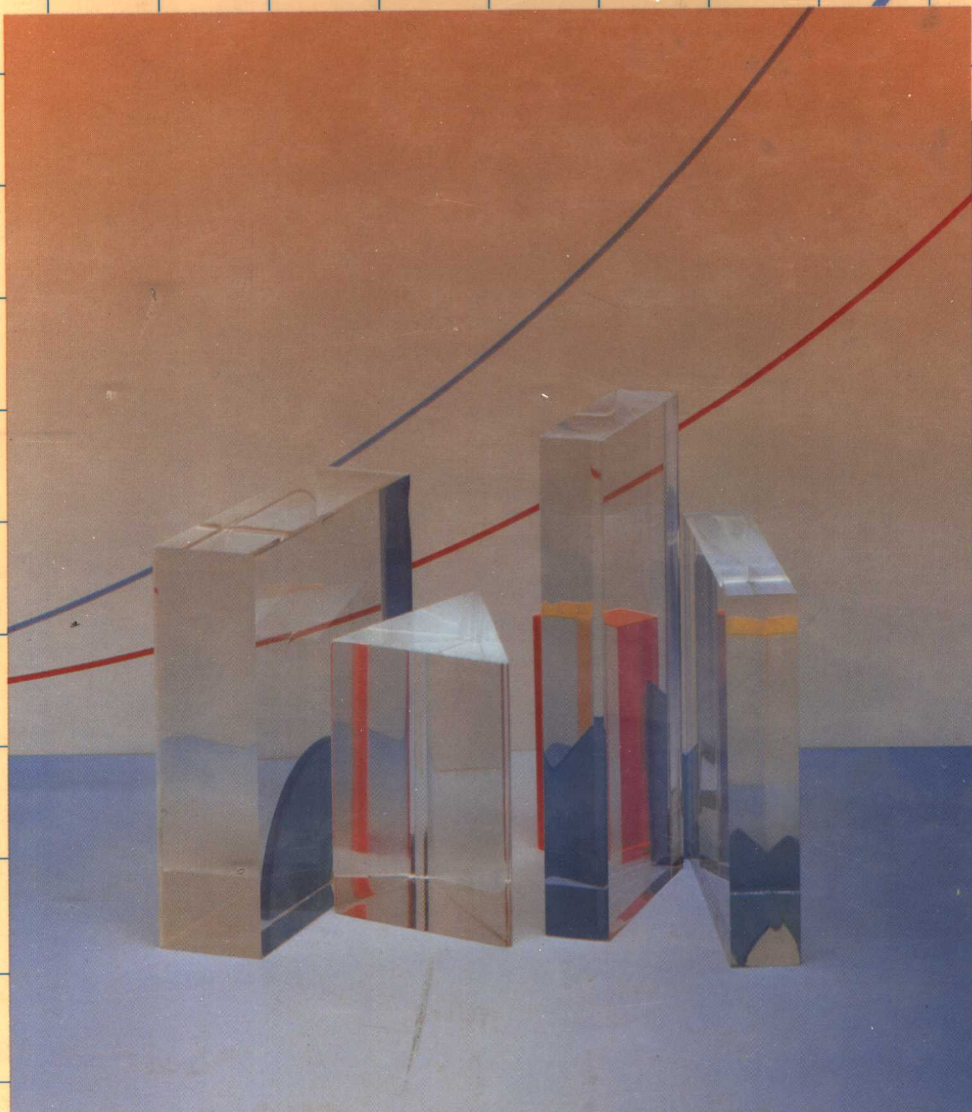
ECONOMICS



HEINZ KOHLER

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PREFACE

Economics is an important subject. Those who master the theoretical knowledge of the discipline can wield a powerful set of tools capable of explaining why people act the way they do and capable of affecting—for better or worse—the lives of millions around the world. However, as practitioners of economics know all too well, the crucial theoretical core of the discipline is far from fixed. It is enlarged each year by a vast amount of newly published research. Typically this new material appears in a mathematical garb that is inaccessible to the beginner. What makes economics remarkable and what accounts for the writing of this book is the fact that the latest theoretical advances can be written up in an intuitive manner and presented in basic textbooks. This fact alone not only justifies but indeed dictates the publication of new principles of economics texts.

Economics is also an exciting subject. This fact is evidenced throughout this text by a continual link between theory and applications. Such is the case with measurement issues concerning unemployment, price level changes or the potential GNP, with capital budgeting procedures and the determinants of investment demand, and with the effects an open economy has on the effectiveness of fiscal and monetary policies. This is also the case with principal-agents issues that lead to discussions of corporate raiders, takeover battles, and general problems of economic incentives; as well as with hundreds of other subjects, ranging from comparable worth to logrolling, from price discrimination to pollution rights, and from persuasive advertising to prisoners' dilemma games.

Nearly two hundred other applications, on the other hand, have been set off as self-contained boxed examples. Consider just some of the topics: *From Macroeconomics* there are The AD-AS Model and the Great Depression; How Milwaukee Boomed But Left Its Blacks Behind; Counting the Unemployed in Iowa City; The Gradual Internationalization of the Yen; National Saving: The U.S. Versus Japan; The U.S. Labor Force: Unqualified to Work; From Marx to the Market: Problems of Transition; and South Korea's Economic Miracle. *From Microeconomics* there are The Guiding Hand of MITI; The Internationalization of the Beer Brewing Industry; Broadway and the Bottom Line; Challenging Airfone's Monopoly; The Convergence of Bank Credit Cards; Selling Football Teams; Antitrust in a Global Economy; Computer Software: a Public Good; and The Welfare Trap.

To the Instructor

As noted above, this text aims to introduce the beginning student to the most up-to-date theoretical knowledge that economists possess. It also illustrates the usefulness of economic theory with a wealth of applications. But there is more. Having taught economic principles continuously for over thirty years, I know that too many texts race too quickly through the important ideas in economics. As a result—year in, year out—students stumble on the same set of concepts. Most chapters of this text, therefore, contain *caution boxes* that identify the common traps into which students often fall. Additionally, special "Ideas in History" sections provide valuable perspectives on how the theoretical tools of modern day economists were fashioned, and by whom. The more than two dozen such boxes focus on such topics as the Division of Labor, the Proper Economic Role of Government, the Theory of Comparative Advantage, National Income Accounting, The Keynesian Revolution, Monetarism and Discretion Versus Rules, the Rational Expectations Revolution, the New Keynesians, the Marginalist Revolution, the Nature of the Firm—the list goes on.

Most important, perhaps, is still another feature. The trend in new (and revised) principles of economics texts is to recognize the international setting of a single economy (like the American one) and integrate various international vignettes throughout the text. This text takes the "international evolution" a step further by covering such topics as comparative advantage, the strategic trade model, and exchange rate theory early in the text (in Chapter 4) and then integrating the use of these ideas throughout.

The book is divided into ten parts. Part I, Basic Concepts, introduces scarcity, choice, and optimizing (Chapter 1); the nature of economic systems and how economists theorize about them (Chapter 2); the fundamentals of demand and supply (Chapter 3); and the important role of international trade in boosting the wealth of nations (Chapter 4).

Part II, Measuring the Macroeconomy, introduces the concept and measurement of the gross national product (Chapter 5), and then turns to measurements of economic fluctuations, unemployment, and inflation (Chapter 6).

Part III, Basic Macroeconomic Theory and Fiscal Policy, introduces the modern model of aggregate demand and aggregate supply (Chapter 7), and then provides an overview of macroeconomic controversies involving classical economists, Keynesians, monetarists, supply siders, and new classical economists (Chapter 8). This thorough introduction is followed by a consideration of the determinants of consumption and investment demand (Chapter 9), the building of a basic Keynesian model of nominal GNP determination (Chapter 10), and a study of the government sector and fiscal policy (Chapter 11).

Part IV, Money and the Complete Macro Model, introduces financial markets (Chapter 12), the nature of money, commercial banks, and central banking (Chapter 13), and the Federal Reserve's monetary policy (Chapter 14). The macro model is completed by integrating balance-of-payments concerns and foreign exchange markets with earlier fiscal and monetary policy discussions (Chapter 15). A summary chapter considers the complete macro model from the perspectives of competing schools of thought (Chapter 16).

Part V, The U.S. Experience, focuses on economic growth and productivity (Chapter 17), governmental policies to reduce unemployment (Chapter 18), and policies to fight inflation in the context of unstable short-run Phillips curves (Chapter 19).

Part VI, A Worldwide View, in turn, describes and analyzes economic institutions and policies outside the United States. Special emphasis is placed on the rise and fall of communism (Chapter 20) and the problems faced by the world's less developed countries (Chapter 21).

Part VII, Households and Firms, introduces consumer preferences and demand (Chapter 22), elasticity (Chapter 23), the nature of the firm, including principal-agent issues, takeover battles, and the like (Chapter 24), the technology of production (Chapter 25), and the costs of production (Chapter 26).

Part VIII, Markets for Goods, covers perfect competition (Chapter 27), monopoly and cartels (Chapter 28), and oligopoly and monopolistic competition (Chapter 29).

Part IX, Markets for Resources, deals with perfectly competitive labor markets (Chapter 30), imperfectly competitive labor markets (Chapter 31), markets for natural and capital resources (Chapter 32), and the personal distribution of income and the problem of poverty (Chapter 33).

Part X, Government in the Microeconomy, explores the role of government in greater depth than earlier discussions of price fixing, excise taxes, and labor market laws allowed. This final section of the text addresses antitrust policy (Chapter 34), economic and social regulation (Chapter 35), externalities and environmental economics (Chapter 36), public goods and public choices (Chapter 37), and the redistribution of income (Chapter 38). For those who wish to explore how government might help create more equal opportunities for people to *earn* their own income, an optional chapter, The Economics of Health, is offered in the *Student Workbook* that accompanies this text.

Numerous support items have been designed to help the instructor. Some of these are built into the back of the book—a complete Glossary of key concepts and Solutions to Odd-Numbered Questions and Problems. In addition, there are a number of Appendices introducing the use of graphs in economics (Appendix 1a) a multiplier-accelerator model of the macroeconomy and, thus, the role of mathematics in economics (Appendix 10a); indifference curve analysis (Appendix 22a); major concepts of business accounting (Appendix 24a); and isoquant analysis (Appendix 25a). Other support items—all written by the author of the text—include an *Instructor's Manual*, a *Test Bank*, a *Student Workbook*, and the MACEC and MICEC personal computer diskettes. The *Instructor's Manual* combines answers to the even-numbered end-of-chapter questions and problems in the text as well as various teaching suggestions. The *Test Bank* includes 75 multiple-choice questions for each text chapter (not duplicated in the *Student Workbook* described in the next section). The computer programs are also described below.

To the Student

This text comes with a number of study aids designed to make your work easier and more successful than it would otherwise be. Some of these aids are built into the text. Consider the chapter summaries, end-of-chapter listings of Key Concepts (boldfaced in the text), end-of-chapter Questions and Problems, Solutions to odd-numbered items at the back of the book, and a complete Glossary of all the key concepts. More important, perhaps, a separate *Student Workbook* is also available. For each chapter of the text, it contains 35 multiple-choice questions, 12 true-false questions, and a number of problems—along with detailed solutions and answers to all of these. In addition, you will find a listing of Selected Readings if you want to pursue any given topic further than the text. Finally, note the availability of MACEC and MICEC, two personal computer diskettes that enable you to work hundreds of exercises in macroeconomics and microeconomics.

The MACEC Personal Computer Programs

A set of programs for IBM personal computers and compatible machines has been specially designed to accompany this text. Two basic types of programs are included:

1. A Capital Budgeting program allows users to explore the forces that determine investment demand. Users can work out compounding, discounting, and net present value problems. Thus, they can evaluate potential investment projects by examining their negative and positive cash flows over time and finding their net present values at alternative discount rates as well as their internal rates of return.

2. A Macro Models program allows users to explore a variety of macroeconomic models and to simulate the effects of fiscal and monetary policy therein. Users can raise or lower government demand, change lump-sum taxes (or income tax rates), and use one or more of the monetary policy tools (engaging in open market operations, setting the discount rate, and setting the required reserve ratio). The computer then provides old and new values of the GNP and other key macroeconomic variables and asks questions to help users understand *how* their policies affect the economy.

Initial Start-Up Procedure

1. Unless the DOS prompt is **A>**, type **A:**
Then press the Enter key. At this point, the prompt should be A>.

2. Now place the MACEC diskette into drive A and type: **MACEC**
Then press the *Enter* key.

Hard Disk Installation Instructions

Instructions on how to install the programs on a computer hard disk are provided on the diskette itself. Simply follow the start-up procedure noted above, and you will find the instructions.

The MICEC Personal Computer Programs

A set of programs for IBM personal computers and compatible machines has been specially designed to accompany this text. The computer must have graphics capability. The 10 programs cover the following aspects of the text:

1. Demand and Supply
2. The Production Function
3. Costs
4. Profit-Maximization: Perfect Competition
5. Profit-Maximization: Imperfect Competition
6. Labor Markets
7. Capital Budgeting
8. Regulation
9. Externalities
10. Public Goods

The programs include about 350 graphical and tabular exercises on the subjects noted above, as well as mathematical programs to work out compounding, discounting, and net present value problems.

Initial Start-Up Procedure

Given the DOS prompt, such as **A**>, place the diskette into the computer and type:

A : MICEC

Then press the *Enter* key. Naturally, if you have placed the diskette into another drive (such as **B**), replace the **A** above by a different appropriate letter (such as **B**).

Hard Disk Installation Instructions

Instructions on how to install the program on a computer hard disk are provided on the diskette itself. Simply follow the start-up procedure noted above, and you will find the instructions.

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I would like to express my sincere gratitude to many who have helped me in the creation of this text. Many reviewers, listed below, took time to examine at least a portion of the text and gave me good advice. Often I took it; to the extent that I did not, only I am to blame.

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