



THE ECONOMY TODAY

Fourth Edition

BRADLEY R. SCHILLER

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The American University



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ABOUT THE AUTHOR

Dr. Bradley Schiller has two decades of experience teaching introductory economics at The American University, the University of California (Berkeley and Santa Cruz), and the University of Maryland. Dr. Schiller's unique contribution to teaching is his ability to relate basic principles to current socioeconomic problems, institutions, and public policy decisions. This perspective is evident throughout *The Economy Today*.

Dr. Schiller derives this policy focus from his extensive experience as a Washington consultant. He has been a consultant to most major federal agencies, many congressional committees, and political candidates. In addition, he has evaluated scores of government programs and helped design others. His studies of discrimination, employment and training programs, tax reform, pensions, welfare, and Social Security have appeared and been cited in both professional journals and popular media. Dr. Schiller is also a frequent commentator on economic policy on radio shows.

Dr. Schiller received his Ph.D. from Harvard in 1969. His B.A. degree, with great distinction, was completed at the University of California (Berkeley) in 1965. He is now a professor of economics in the School of Public Affairs at The American University.

Fourth Edition

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Preface

The world isn't really getting any smaller. But it does seem that the rest of the world is getting closer. Five years ago, neither the trade deficit nor the value of the yen grabbed any headlines. Now the yen value is a staple of the daily news, and the Commerce Department's monthly report on the trade deficit is a climactic event that sends reporters and stock traders scurrying to their computers. This is a new way of life. Only a few short years ago, things were different. Headline stories focused on federal *budget* deficits and the financial markets were riveted to weekly changes in the domestic money supply. Few people worried about foreign markets, trade deficits, or exchange rates.

We now realize that the rest of the world cannot be dismissed so lightly. The performance of U.S. markets is profoundly influenced by external forces. And the rest of the world is directly affected by changes in U.S. output, consumption, and financial markets. Economic growth and advanced technology have increased both the extent and visibility of our global interdependence. The foremost objective of this fourth edition is to incorporate this new international awareness into *The Economy Today*.

INTERNATIONAL OUTLOOK

The global perspective of the fourth edition differs markedly from any other principles text on the market in very visible ways.

World Views

The most obvious references to the international economy are the new World View boxes. These boxes supplement the core text material with events that illustrate the *global* nature of economic performance and policies. The core discussion of money, for example, includes World Views on international money flows (p. 287) and the associated difficulties of controlling the money supply (p. 300). The new chapter on the national debt includes international comparisons of deficits and debt (p. 390). The warming of the atmosphere due to air pollution—the

so-called greenhouse effect—provides a superb illustration of global externalities (p. 692). Other micro World Views include European farm subsidies (p. 670), restrictions on smoking (p. 454), deregulation of London's financial markets (p. 652), and contestable markets (p. 583). Altogether, there are sixty-three World Views, each labeled with a distinctive logo and set against a color-tinted background.

Self-contained Macro Chapter

The World Views provide a constant reminder of the global environment in which the U.S. economy functions. By themselves, however, they do not *teach* any new principles. This function is assumed by an all-new chapter, "Global Views."

The foremost obstacle to covering international topics in a one-semester macro course is time. With traditional textbooks, separate chapters on comparative advantage (trade theory) and exchange rates (international finance) had to be assigned before any semblance of an international discussion could take place. There simply wasn't enough time to cover both chapters. And trying to explain the international dimensions of macro policy without that foundation confused more than it clarified. So international aspects of the macro economy were simply omitted or treated as footnotes in the core macro sequence.

Chapter 17 of this edition offers a more attractive alternative. It is intended as a one-stop, self-contained introduction to the international dimensions of the macro economy. It provides just enough discussion of trade and exchange rates so as to explain how the international economy affects U.S. economic performance. It emphasizes the constraints that external forces place on domestic monetary and fiscal policies. This global view helps students understand why policy makers and financial analysts worry about international markets, and what prompts demands for greater global coordination of macro policies.

Notice that this global view (Chapter 17) is positioned before both trade theory (Chapter 36) and international finance (Chapter 37). That placement emphasizes the utility of this new chapter as a self-contained discus-

sion of international macroeconomics. It can also be used as a capstone to a more extended treatment of international topics (e.g., following Chapters 36 and 37), but will stand alone in courses with less time for international coverage.

Topic Coverage

The traditional chapters of the international sequence have been improved as well. Chapter 36 provides more detail on trade flows and bilateral balances, while Chapter 37 offers a new discussion on the balance of payments. The international debt crisis gets more attention in Chapter 38, where the conflicting interests of creditor and debtor nations are discussed.

All of these features ensure that students cannot read *The Economy Today* without gaining an awareness of the global dimensions of U.S. economic performance.

DEBT AND DEFICITS

Although international topics are on the front page these days, there is still a lot of domestic material to cover. One of the topics allocated more space in this edition is the national debt. The all-new Chapter 16 traces the history of the national debt from that first “shot heard round the world” in 1775. The Continental Congress borrowed funds from France and Spain to finance the Revolutionary War. Did debt-financing change the cost of independence or enable the Continental Congress to pass that cost on to later generations?

With this historical perspective as a foundation, Chapter 16 examines the true “burden” of the national debt and how it is distributed. A careful distinction is drawn between internal and external debt. The chapter also discusses the purpose and impact of legislative debt and deficit ceilings. This chapter can be used immediately after the discussion of fiscal policy (Chapter 10) or later in the macro sequence.

GOVERNMENT FAILURE VS. MARKET FAILURE

Chapter 3 has been rewritten to provide a broader perspective on the purpose and limitations of government intervention. The chapter begins with the various macro and micro failures that justify government intervention. This discussion of market failures sets the framework for describing the actual behavior of federal, state, and local

governments. The chapter ends with consideration of potential gaps between theory and reality. Government intervention might not achieve its objectives and could even worsen the economic outcomes. Indeed, a majority of taxpayers appears to believe such “government failure” is likely. The concluding section of Chapter 3 examines some of the reasons—including public choice theory—why government intervention may not live up to its potential.

MICRO REORGANIZATION

The core theory chapters in the micro section have been subjected to a lot of editing. This includes a reorganization of several topics. Chapter 2 has been expanded to include a discussion of shifts in demand and a whole new section on supply. The description of business firms and discussion of growth sources have been moved out of Chapter 20, leaving more room for basic discussions of economic cost.

The introduction to imperfectly competitive firms (and their downward-sloping demand curves) has been deleted from Chapter 21. In its place there is a longer discussion of supply determinants and a new section on supply shifts. The same kind of change has been made in Chapter 22: the introduction to monopoly has been deleted in favor of more discussion of short- and long-run competitive equilibrium. This new organization is less confusing and offers a more solid foundation for the micro sequence.

The chapters on regulation and firm productivity have also been reversed. The discussion of regulatory intervention (Chapter 26) now follows immediately after the core sequence on the theory of the firm. Chapter 29’s emphasis on internal productivity and management is now positioned to provide a smoother transition from production theory to labor theory.

The functional distribution of income now serves as an introduction to “Rent, Interest, and Profit” (Chapter 33). This frees up space in Chapter 34, “Taxes: Equity vs. Efficiency,” to cover tax incidence in greater detail. Chapter 34 also uses the Tax Reform Act of 1986 to highlight basic trade-offs between equity and efficiency.

MORE EXPLICIT THEORY

The theoretical content of *The Economy Today* has been tightened by eliminating some of the redundancies pointed out by adopters and reviewers of the earlier edition. The theory, too, has been made more explicit through the addition of equations and formulas.

Chapter-opening questions have been added to focus attention on key issues and concepts. In addition, more problems have been added to the chapter-end material. These problems should improve students' critical thinking skills by integrating economic concepts with examples that require calculation and graphical use of data. There is now a close integration between the problems at the end of every chapter and the problems that appear in the supplementary package.

ENDURING FEATURES

The new ingredients of *The Economy Today* improve on a formula that has been proven to be popular. The distinctive elements of that formula include:

Balanced Macro Theory

Although Keynesian theory remains the central core of the macro sequence, monetarist, supply-side, and the New Classical economics perspectives all get a favorable hearing. The objective of *The Economy Today* is not to "sell" one particular point of view but instead to introduce students to the controversies that accompany both theory and policy. Unless competing views are explained on their own best terms, how can students make sense of the persistent debates that occur in classrooms and Congress? This text emphasizes competing views and explains their differing implications for economic policy. The graphs on page 322, the tables on pages 310–311, and the illustrations on page 359 illustrate the kind of explicit comparisons *The Economy Today* offers.

Real-World Focus

All principles texts on the market today claim to emphasize "real-world" examples and issues. *The Economy Today* does more than pay lip service to this claim. To attain a credible real-world focus, one must begin with empirical examples, blend reality into the text, offer repeated illustrations of concepts and theories, and offer insights into policy issues. *The Economy Today* does this in every chapter. There is a constant interplay between theoretical principles and real-world events. This interplay makes economic principles look "alive"—something worth learning about. The motivational benefit of this real-world focus has been proven repeatedly.

Theory vs. Reality

The real-world focus of *The Economy Today* generates a demand to explain the gap between real-world performance and theoretical potential. The fourth edition again responds to this demand. Nowhere is this more evident than in Chapter 15 ("Theory and Reality"). Chapter 15 serves several functions. First, it provides an expanded review of competing macro theories by illustrating their idealized use under conditions of recession, inflation, and stagflation (pp. 357–361).

After providing this theoretical tour de force, Chapter 15 focuses on real-world policy constraints. These include competing goals, measurement problems ("Where's the fire?"), design problems ("How can we put it out?"), and implementation problems ("Can we get there in time?"). After reviewing this maze of policy obstacles, students may have some sympathy for the errors of economic policy. A World View on comparative performance will also convince them that suboptimal outcomes are not a uniquely American phenomenon.

Timely Topics

The Economy Today continues to offer the most complete coverage of the issues and events that are in the journals and newspapers today. Among the topics introduced in this edition are:

MACRO

- government failure (Chapter 3)
- stock market crashes of 1929 and 1987 (Chapter 5)
- labor scarcity in the 1990s (Chapter 6)
- the new (January 1988) Consumer Price Index (Chapter 7)
- transfer payments and fiscal policy (Chapters 10 and 16)
- zero-coupon bonds (Chapter 12)
- money targets and global money (Chapter 13)
- tax elasticity of supply (Chapter 14)
- New Classical economics (Chapter 15)
- origins and impacts of the national debt (Chapter 16)
- international constraints on macro policy (Chapter 17)
- productivity trends (Chapter 18)

MICRO

- smoking restrictions and demand theory (Chapter 19)
- the economic cost of homework (Chapter 20)

- 1986 Tax Reform Act (Chapters 21 and 34)
- contestable markets (Chapters 23, 24, 25, and 26)
- the price of brand loyalty (Chapter 24)
- London's "Big Bang" (Chapter 26)
- Farm Security Act of 1985 (Chapter 27)
- the greenhouse effect (Chapter 28)
- corporate control (Chapter 29)
- elasticity of labor supply (Chapter 30)
- starting salaries for lawyers and MBAs (Chapter 31)
- 1987 auto and football strikes (Chapter 32)
- Workfare and EDfare reforms (Chapter 35)

INTERNATIONAL

- the Uruguay round of GATT negotiations (Chapter 36)
- balance of payments (Chapter 37)
- the debt crisis (Chapter 38)
- decentralization reforms in China and Russia (Chapter 39)

CAREFUL PEDAGOGY

The timely topics, real-world illustrations, and lively style of *The Economy Today* are all designed to make economics more interesting to the average student. Motivating students to learn is not enough, however. A text must also "teach" basic principles. This demands careful, clear development of basic principles, reinforced with a variety of learning aids.

In-Text Learning Aids

CHAPTER PREVIEW Each chapter begins with a narrative introduction to the content and purpose of the chapter. Basic questions to be answered are included in each preview and highlighted with colored bullets (e.g., p. 5).

RUNNING GLOSSARY Definitions of key terms are provided in the margins to facilitate retention and quick review. Definitions are repeated in successive chapters where they are relevant, in recognition of the fact that students do not always remember basic terms after only one "lesson." All of these terms are compiled into a complete glossary, with chapter references, at the end of the book.

FULLY ANNOTATED GRAPHS AND TABLES All graphs and tables in the text are accompanied by self-contained captions. These reinforce the in-text discussions and facilitate quick review.

SYNCHRONIZED TABLES AND GRAPHS Students often have difficulty relating graphs and tables. To help them, contents of related schedules and graphs are explicitly synchronized with the aid of labeled rows (in schedules) and dots (on graphs). The demand schedule and curve in Chapter 2 illustrate this feature.

EXPLICIT FORMULAS The fourth edition makes key formulas more explicit. Basic equations are set off in the text on a separate line and highlighted in color. (See p. 26 for an example.)

IN THE NEWS The real-world emphasis of *The Economy Today* is reinforced with brief news clippings, public opinion polls, and excerpts from journals. In the News boxes, with a distinctive logo, clearly distinguish these examples from the flow of the basic text. Each news box includes a key-term descriptor to relate it to core concepts.

WORLD VIEWS The World View boxes offer similar illustrations, drawn from the international economy. These examples are set apart in shaded boxes with a distinctive logo and key-term descriptor. (See p. 50 for an example.)

POLICY IMPLICATIONS Every theory chapter contains a brief discussion of a specific policy implication that reinforces basic principles.

NARRATIVE SUMMARIES Chapter summaries highlight basic points and principles in brief, sequenced paragraphs.

KEY-TERM REVIEW Each chapter ends with a list of key terms for quick review. These lists include all terms in the running glossary of the chapter.

DISCUSSION QUESTIONS Four or five discussion questions are provided at the end of each chapter for student review, class discussion, or homework assignments.

NUMERICAL AND GRAPH PROBLEMS Additional problems, often using graphs, have been added to the end of each chapter. These test the student's ability to solve typical exam-type problems. Answers to the problems are in the *Instructor's Resource Manual*.

A COMPLETE TEACHING AND LEARNING PACKAGE

The Economy Today continues to be guided by two maxims. First is the simple proposition that you can't teach someone until you get his/her attention. The travails of the fictional ABC Company trying to wring profits from widget production rarely rivet anyone's attention, but the

real-life stories in *The Economy Today* will spark student interest.

The second guiding maxim is that the text has got to get it right the first time. Painstaking efforts are made to keep *The Economy Today* error-free, from beginning to end. The dedication of a single author also assures consistency of style, level, and approach throughout the text.

PAPERBACKS

In this edition, the text is again available in paperback splits. The macro half contains Chapters 1–18 and 36–39. The micro half contains Chapters 1–3 and 19–37.

STUDENT LEARNING AIDS

Study Guide

There are several supplements available to accompany the text itself. From the student's perspective, the most important of the supplements is the *Study Guide*, prepared by Professors Lawrence Ziegler at the University of Texas (Arlington) and Michael Tansey at Rockhurst College. There is a full-text *Study Guide* and, for the first time, macro and micro versions are also available. Each chapter of the *Study Guide* contains these features:

QUICK REVIEW Key points in the text chapter are restated at the beginning of each *Study Guide* chapter. The reviews are parallel to and reinforce the chapter summaries provided in the text.

LEARNING OBJECTIVES The salient lessons of the text chapters are noted at the outset of each *Study Guide* chapter. These objectives focus the student's study and help to ensure that key points will not be overlooked. The objectives are keyed to the exercises in the *Study Guide* to help reinforce learning.

KEY-TERM REVIEW Early in each chapter the students are asked to match definitions with key terms. This relatively simple exercise is designed to refresh the student's memory and provide a basis for subsequent exercises.

TRUE-FALSE QUESTIONS Twenty or so true-false questions are provided in each chapter. These questions have been class tested to ensure their effectiveness in highlighting basic principles.

MULTIPLE-CHOICE QUESTIONS Approximately fifteen multiple-choice questions per chapter are provided. These

questions allow only one correct answer and also focus on basic principles.

PROBLEMS AND APPLICATIONS There are more than forty exercises in the *Study Guide*, most of which stress current issues and events.

MEDIA ASSIGNMENTS New to this edition are media assignments that require the student to find an example from the media to illustrate an economic concept.

COMMON ERRORS In each chapter of the *Study Guide*, errors that students frequently make are identified. The bases for those errors are then explained, along with the correct principles. This unique feature is very effective in helping students discover their own mistakes.

ANSWERS Answers to *all* problems, exercises, and questions are provided at the end of each chapter. Difficult problems have annotated answers. These answers make the *Study Guide* self-contained, thus allowing students to use it for self-study.

Graphics Tutor

The *Graphics Tutor* is available in three packages: microeconomics, macroeconomics, and principles of economics. Each package presents tutorials that help students learn fundamental ideas in economics through the extensive and dynamic use of graphs.

Microcomputer Simulations

Also available is a set of six microcomputer simulations by Rae Jean Goodman of the U.S. Naval Academy: three in macroeconomics (fiscal policy, monetary policy, and budget and deficit analysis) and three in microeconomics (supply and demand, market power—in the microcomputer industry—and price/output decisions).

INSTRUCTOR TEACHING AIDS

We have tried to make the learning process easier for teachers as well as students. To this end, the teaching package includes several items valued by instructors:

News Flashes

As up-to-date as *The Economy Today* is, it can't foretell the future. As the future becomes the present, however,

Bradley Schiller writes *News Flashes* describing major economic events and relating them to specific text references. Four to six *News Flashes* are sent to adopters each year.

Instructor's Resource Manual

The purpose of the *Instructor's Resource Manual* is to provide a ready source of lecture and discussion material for classroom teaching. To this end, it offers a variety of material, including:

A BRIEF INTRODUCTION The first paragraph or two of each chapter provides an overview of the text chapter. In some chapters, there are suggestions for ways of heightening student interest in the material.

CHAPTER OUTLINE This section provides a complete annotated outline of the text chapter. It can be used for building lectures or it can be distributed to students as a study guide.

QUESTIONS AND DISCUSSION This section repeats the questions from the end of the text chapter and provides answers or guidelines for answers to all questions.

ANSWERS TO PROBLEMS Here you will find the answers to all problems at the end of the text chapters.

TAKE A STAND This section takes an issue in the chapter which is illustrated by either an In The News or World View box and poses a controversial question on it. The question is followed by one paragraph in support of the issue and one paragraph in opposition. No resolution of the issue is offered. Take a Stand is intended to motivate classroom discussion or to form the basis for essay-type questions.

MEDIA EXERCISES New to this edition, these tear-out assignments require the student to find an example from the media to illustrate an economic concept. There is approximately one per chapter. After each exercise, professor's notes and lecture opportunities are provided.

SUPPLEMENTARY RESOURCES This final section provides two kinds of information. First, it contains annotated references of videotapes or films relevant to the text chapter. Second, it contains a brief bibliography of articles and books which can be used for additional reading assignments or suggestions for students. These also provide a quick guide of sources to use for expanding lecture materials.

Test Bank

A thoroughly revised *Test Bank* was prepared for this edition, with more than 50 percent of the questions being new and many others revised. The *Test Bank* includes thirty-nine chapter tests of approximately 65 multiple-choice and true-false questions per chapter, totaling 2,712 questions. There are two levels of questions. The first requires the simple recall of facts, definitions, or basic reasoning. The second level is analytical, requiring more complete comprehension of theory and an understanding of functional relationships. Most of the *Test Bank* questions are cross-referenced directly to the learning objectives in the *Study Guide*.

RANDOM HOUSE TESTMAKER A computerized version of the *Test Bank* is available to adopters. This program enables instructors to view, edit, and test questions to create exams. Questions can be selected based on level of difficulty or learning objective.

CUSTOMIZED TEST Instructors may have tests custom prepared by the publisher by calling the publisher's special test service. Masters prepared from the *Test Bank* will be mailed out within 72 hours.

Overhead Transparencies

One hundred of the key tables and graphs in the text have been reproduced as two-color overhead transparency acetates. These are made available to users by the publisher.

ACKNOWLEDGMENTS

The Economy Today has benefited greatly from the dedicated and enthusiastic efforts of many individuals, all working toward making the fourth edition the most complete and current teaching package.

Authors of the Teaching Package

Larry Ziegler (University of Texas, Arlington) and Michael Tansey (Rockhurst College) have set a new standard for student workbooks, thanks to Larry and Mike's strong commitment through all four editions.

John Conant (Indiana State University) inherited a test bank that had been developed and nurtured by Michael Ellis (Texas Wesleyan College) in prior editions. John brought fresh ideas and countless new questions to

the *Test Bank*. The *Instructor's Resource Manual* has been significantly revised and thoroughly updated by Donald Pearson (Eastern Michigan University). William Gunther (University of Alabama) enhanced his innovative *Computerized Graphics Tutor* for this edition. I am dependent on all of these individuals for the success of the teaching and learning package. In addition, these authors also provided me with extensive suggestions on improving the text.

Reviewers

Users of prior editions and reviewers of this edition's draft have contributed greatly to the quality of the fourth edition. As in earlier editions, Martha Olney (University of Massachusetts) and Walter Johnson (University of Missouri) have done the most to lengthen my workday. The seemingly tireless reviewers who have improved the text include:

Carl Austermler, Oakland Community College
 Dan Barszcz, College of DuPage
 Burley Bechdolt, Northern Illinois University
 Mark Berger, University of Kentucky
 Allen Bradley, San Jacinto College
 Kathleen Bromley, Monroe Community College
 Curtis Clark, Eastfield College
 Bruce Cofer, Louisiana College
 John Conant, Indiana State University
 Robert Corcoran, Middle Tennessee State University
 Paul Estenson, Gustavus Adolphus College
 Rudy Fichtenbaum, Wright State University
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 Ron Schuelke, Santa Rosa Junior College
 Teresa Sherrouse, Augusta College

Publishing Team

I am grateful to Random House for assembling the reviewers and authors who have helped develop this fourth edition. Special thanks go to June Smith for her direction and guidance throughout all four editions. Bonnie Binkert, Catherine Woods, Holly Gordon, and Laura Lamorte worked hard to produce a polished final product. Finally, I would like to offer my thanks to my two former editors, Michael Melody, who got me started, and Paul Shensa, who kept me going.

Inspiration

I conclude with appreciation to my wife Tricia, who tolerates me, and to my children, Justin and Ashley, who promise to read this text someday.

Bradley R. Schiller

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