

FIFTH EDITION

OF



EDWARD T. SCHNEIDER

Essentials *of* Economics

Fifth Edition

Bradley R. Schiller

American University, Washington, D.C.



**McGraw-Hill
Irwin**

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*Essentials of Economics*

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This book is printed on acid-free paper.

domestic 1 2 3 4 5 6 7 8 9 0 VNH/VNH 0 9 8 7 6 5 4
international 1 2 3 4 5 6 7 8 9 0 VNH/VNH 0 9 8 7 6 5 4

ISBN 0-07-287747-2

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Cover image: *Counterweights, 1926* by *Wassily Kandinsky (1866–1944)* *Städtisches Museum, Mulheim, Germany/Bridgeman Art Library*

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Estate: *Contrepoids, 1926, E.R.II.n°778*

Typeface: *10/12 New Aster*

Compositor: *GTS Companies/York, PA Campus*

Printer: *Von Hoffmann Corporation*

Library of Congress Cataloging-in-Publication Data

Schiller, Bradley R., 1943–

Essentials of economics / Bradley R. Schiller.—5th ed.

p. cm.

Various multi-media instructional aids are available to supplement the text.

Includes index.

ISBN 0-07-287747-2 (alk. paper)—ISBN 0-07-111194-8 (international : alk. paper)

1. Economics. I. Title.

HB171.5.S2923 2005

330—dc22

2003065972

INTERNATIONAL EDITION ISBN 0-07-111194-8

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About the Author

Bradley R. Schiller has over three decades of experience teaching introductory economics at American University, the University of California (Berkeley and Santa Cruz), and the University of Maryland. He has given guest lectures at more than 100 colleges ranging from Fresno, California, to Istanbul, Turkey. 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 *Essentials of Economics*.

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, training programs, tax reform, pensions, welfare, Social Security, and lifetime wage patterns have appeared in both professional journals and popular media. Dr. Schiller is also a frequent commentator on economic policy for television, radio, and newspapers.

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 American University.

Economics entails hard choices. No one knows this better than instructors assigned to teach a survey of economics in a single term. There are simply too many topics to cover in so short a time.

Focus on Core Concepts

Few textbooks confront this scarcity problem directly. Some one-semester books are nearly as long as full-blown principles texts. The shorter ones tend to condense topics and omit the additional explanations, illustrations, and applications that are especially important in survey courses. Students and teachers alike get frustrated trying to pick out the essentials from abridged principles texts.

Essentials of Economics lives up to its name by making the difficult choices. The standard table of contents has been pruned to the core. The surviving topics are the very essence of economic concepts. In Section II on microeconomics, for example, the focus is on the polar models of perfect competition and monopoly. These models are represented as the endpoints of a spectrum of market structures (see figure on p. 130). Intermediate market structures—for example, oligopoly, monopolistic competition—are noted but not analyzed. The goal here is simply to convey the sense that market structure is an important determinant of market outcomes. The contrast between the extremes of monopoly and perfect competition is sufficient to convey this essential message. The omission of other market structures from the outline also leaves more space for explaining and illustrating *how* market structure affects market behavior.

The same commitment to essentials is evident in the section on macroeconomics. Rather than attempt here to cover all the salient macro models, the focus is on a straightforward presentation of the aggregate supply-demand framework. The different interpretations of the classical, Keynesian, and monetarist models are discussed. But there is no discussion of neo-Keynesianism, rational expectations, public choice, or Marxist models. The level of abstraction required for such models is simply not necessary or appropriate in an introductory survey course. Texts that include such models tend to raise more questions than survey instructors can ever hope to answer. In *Essentials*, students are exposed only to the ideas needed for a basic understanding of how macroeconomies function.

Central Theme

The central goal of this text is to convey a sense of how economic *systems* affect economic *outcomes*. When we look back on the twentieth century, we see how some economies flourished, while others languished. Even the “winners” had recurrent episodes of slow, even negative growth. The central analytical issue is how various economic systems influenced those diverse growth records. Was the relatively superior track record of the United States a historical fluke or a by-product of its commitment to market capitalism? Were the long economic expansions of the 1980s and 1990s the result of enlightened macro policy, more efficient markets, or just good luck? What role did policy, markets, and (bad) luck play in the economic slowdown of 2001? What forces deserve credit for the economic recovery that followed?

We know how President Bush answered this question. Like his predecessors, President Bush wanted credit for all good economic outcomes and no blame for the bad outcomes (see Headline). But that's just politics. In economics, we want students to at least have an overview of how the economy works and a set of basic tools for identifying cause-and-effect relationships. Students get the bird's-eye view of the macroeconomy with a simple model (see page 252) that relates macro determinants to macro outcomes. Then they get enough tools to sort out the competing claims for credit or blame.

A recurrent theme in *Essentials* is the notion that economic institutions and policies *matter*. Economic prosperity isn't a random occurrence. The right institutions and policies can foster or impede economic progress. The challenge is to know when and how to intervene.

This central theme is the focus of Chapter 1. Our economic accomplishments and insatiable materialism set the stage for a discussion of production possibilities. The role of economic systems and choices is illustrated with the starkly different “guns versus butter” decisions in North and South Korea, Russia, and the United States. The potential for both market failure (or success) and government failure (or success) is highlighted. After reading Chapter 1, students should sense that “the economy” is important to their lives and that our collective choices on how the economy is structured are important.

A Global Portrait of the U.S. Economy

To put some meat on the abstract bones of the economy, *Essentials* offers a unique portrait of the U.S. economy. Few students easily relate to the abstraction of the economy. They hear about specific dimensions of the economy but rarely see all the pieces put together. Chapter 2 tries to fill this void by providing a bird's-eye view of the U.S. economy. This descriptive chapter is organized around the three basic questions of WHAT, HOW, and FOR WHOM to produce. The current answer to the WHAT question is summarized with data on GDP and its components. Historical and global comparisons are provided to underscore the significance of America's \$11 trillion economy. Similar perspectives are offered on the structure of production and the U.S. distribution of income. An early look at the role of government in shaping economic outcomes is also provided. This colorful, global portrait is a critical tool in acquainting students with the broad dimensions of the U.S. economy and is unique to this text.

Real-World Emphasis

The decision to include a descriptive chapter on the U.S. economy reflects a basic commitment to a real-world context. Students rarely get interested in stories about the mythical widget manufacturers that inhabit so many economics textbooks. But glimmers of interest—even some enthusiasm—surface when real-world illustrations, not fables, are offered.


Every chapter starts out with real-world applications of core concepts. As the chapters unfold, empirical illustrations continue to enliven the in-text analysis. Most chapters end with a **Policy Perspectives** section that challenges the student to apply new concepts to real-world issues.

POLICY PERSPECTIVES

Invest in Labor or Capital?

The U.S. labor force continues to grow by more than a million workers per year. If capital investments don't keep pace, these added workers will strain production facilities. The law of diminishing marginal productivity would push wages lower and reduce living standards. Hardly a very cheerful prospect for the next millenium.

To beat the law of diminishing marginal productivity, we have to *increase* the productivity of all workers. This means that we have to *shift* production



The real-world approach of *Essentials* is reinforced by the boxed **Headlines** that appear in every chapter. Like the prior Headline on President Bush, the other 77 Headlines offer up-to-date domestic and international applications of economic concepts. Some new examples include the advent of fee-based music downloads (p. 96); OPEC's supply-management problems (p. 164); soaring salaries for college coaches (p. 188); new doubts about the value of recycling (p. 215); the unsettling effects of terrorism (p. 264); the stimulus from the 2003 tax cuts (p. 287); the threats posed by soaring budget deficits (p. 357). This is just a sampling of the stream of real-world applications that cascades throughout this text.

TARIFFS
HEADLINE


Bush Sets Tariffs on Steel Imports

President Bush imposed temporary quotas yesterday of up to 30 percent on most imported steel in an effort to give the ailing U.S. industry a chance to modernize and restructure. . . .

Industry executives, union leaders and politicians from steel-producing states generally hailed the president's decision. . . .

means—that would raise the price of a \$30,000 car by about \$50 or a washing machine by fewer than \$5. . . .

Ben Goodrich and Gary Hufbauer, economists at the Institute of International Economics, estimate that overall, the 30 percent tariffs will cost U.S. consumers more than \$8 billion, which would only partially be offset by the added profits and



Theory and Reality

In becoming acquainted with the U.S. economy, students will inevitably learn about the woes of the business cycle. As the course progresses, they will not fail to notice a huge gap between the pat solutions of economic theory and the dismal realities of recession. This experience will kindle one of the most persistent and perplexing questions students have, namely: If the theory is so good, why is the economy such a mess? Economists like to pretend that the theory is perfect but politicians aren't. That's part of the answer, to be sure. But it isn't entirely fair to either politicians or economists. In reality, the design and implementation of economic policy is impeded by incomplete information, changing circumstances, goal trade-offs, and politics. Chapter 16 examines these real-world complications. A Headline on the "black art" of economic modeling (p. 368), together with new examples of the politics of macro policy, enliven the discussion. In the end, students get a much more complete explanation of why the real world doesn't always live up to the promises of economic theory.

New Feature: Living Econ

Building on the real-world emphasis of *Essentials*, **Living Econ** is a brand-new end-of-chapter section that promotes economic literacy by relating the chapter concepts to what is most important to every student: his or her own

life. Created by Linda Wilson of the University of Texas at Arlington and Mark Maier of Glendale Community College, **Living Econ** explores provocative and relevant questions such as:

- Is college a good deal?
- Where will I end up?
- How do high prices affect me?
- Should I litter to create jobs?
- How confident am I?
- How do I create money?

By bringing the concepts alive, this section gives students the opportunity to consider why economics matters to them. This glimpse into the big picture will help them see what it takes to think like an economically literate citizen. For those who want a bit more discussion of the topics in **Living Econ**, additional material can be found in the Study Guide.

Is College a Good Deal?

Even though college enrollment is a multimillion dollar decision, many students start college without thinking about the economic consequences. You may be aware of some the benefits. On average a college graduate earns over \$1 million more during his or her lifetime than a high school graduate. (Of course the actual amount depends on your effort and career choice.)

On the cost side, tuition and books are a major expense for college students. However, Chapter 5 points out a cost that is often overlooked, the implicit cost of foregone earnings. You could have worked additional hours instead of going to school and you would have received promotions if you

Living Econ

?

Web Activities



To Keep *Essentials* connected to the real world, each chapter offers **Web Activities** at the end of each chapter. These require the student to access data or materials on a website, then use, summarize, or explain it in the context of the chapter's core economic concepts. The *Instructors Resource Manual* provides answers to these problems as well as additional URLs and web-based exercises.

New in This Edition

Besides the new Internet content, there is a lot of new material in this fifth edition. Although the structure of the text is unchanged, the content has been extensively refreshed throughout. All of the statistics have been updated. New problems and discussion questions have been added to every chapter. New cartoons and photos have been added. And new examples, illustrations, and Headlines appear throughout. In fact, so much material is new that a brief checklist can't do justice to this edition's freshness. The following list should therefore be regarded as a mere sampler:

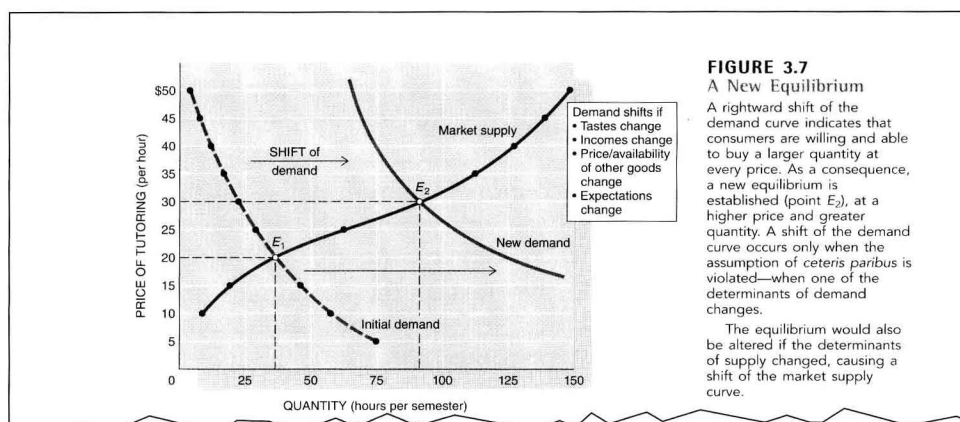
- *Chapter 1: The Challenges of Economics* The “guns versus butter” debate comes to life with the contrast of North Korea’s famine and military build-up, as well as a depiction of the real “Cost of War” in Iraq.

- *Chapter 2: The U.S. Economy* New global contrasts of output levels, production processes, and income distributions add substance to the core WHAT, HOW, and FOR WHOM questions.
- *Chapter 3: Supply and Demand* New evidence on how higher liquor prices quell campus drinking highlights the role of prices in changing consumer behavior.
- *Chapter 4: Consumer Demand* The emergence of fee-based music downloads showcases the importance of price elasticity. Also highlighted are the effects of New York City's new tax on cigarettes.
- *Chapter 5: Supply Decisions* The expansion of McDonald's in China illustrates the distinction between investment decisions and production decisions.
- *Chapter 6: Competition* The escalating international competition in the U.S. catfish market is a great illustration of competitive dynamics.
- *Chapter 7: Monopoly* As Linux has learned, lawsuits can be an effective entry barrier. Paying rivals to suppress innovation helps maintain market power, as well. These are some of the insights into monopoly behavior offered in Chapter 7.
- *Chapter 8: The Labor Market* The government sets a wage *minimum* but not a wage *maximum*. Is that why corporate CEO pay seems so out of whack?
- *Chapter 9: Government Intervention* Opinion polls still register high levels of doubt about the efficacy of government intervention. How do *government failure* and *market failure* compare?
- *Chapter 10: The Business Cycle* Just as the economics profession was getting complacent about the "New Economy," along came another recession. This chapter explores the basics for pursuing full employment, price stability, and economic growth.
- *Chapter 11: Aggregate Supply and Demand* The external shocks to both AS and AD from terrorist attacks underscore the potential instability of macro equilibrium. The critical role of consumer confidence in keeping the wheels of commerce turning is also highlighted.
- *Chapter 12: Fiscal Policy* The sequence of President Bush's tax cuts spotlights the potential of this macro policy lever.
- *Chapter 13: Money and Banks* The changing forms of payment help illustrate the essential characteristics of "money" and the role of banks.
- *Chapter 14: Monetary Policy* The Fed pulled out all the stops to revive the economy after the 2001 terrorist attacks and recession. This chapter explains how monetary policy works.
- *Chapter 15: Economic Growth* New evidence on the role of institutions in fostering growth enlivens the discussion. The presumed limits to growth are also explored.
- *Chapter 16: Theory and Reality* Everyone's favorite chapter keeps getting better. After reviewing the potential of economic policy, an array of real-world policy obstacles is surveyed. The "black art" of macroeconomic models and the politics of fiscal and monetary policy get their due.
- *Chapter 17: International Trade* Steel tariffs and the continuing dispute over China's currency highlight trade potential and problems. The Policy Perspective focuses on the various opponents to a strengthened World Trade Organization.

Supportive Pedagogy

The emphasis on real-world applications motivates students to read and learn basic economic concepts. This pedagogical goal is reinforced with several in-text student aids. These include

- *Chapter-opening questions* Each chapter begins with a short, empirically based introduction to key concepts. Three core questions are posed to motivate and direct student learning.
- *In-margin definitions* Key concepts are highlighted in the text and defined in the margins. Key definitions are also repeated in subsequent chapters to reinforce proper usage.
- *Precise graphs* All the analytical graphs are plotted and labeled with precision. This shouldn't be noteworthy, but other texts are surprisingly deficient in this regard.



- *Synchronized tables and graphs* The graphs are made more understandable with explicit links to accompanying tables. Notice in Figure 3.2 (p. 161), for example, how the lettered rows of the table match the lettered points on the graph.
- *Complete annotations* All the graphs and tables have self-contained annotations, as do the Headline boxes, the photos, and the cartoons. These captions facilitate both initial learning and later review.
- *Chapter summaries* Key points are summarized in bulleted capsules at the end of each chapter.
- *Key-term review* A list of key terms (the ones defined in the margin) is provided at the end of each chapter. This feature facilitates review and self-testing.
- *Questions for discussion* These are intended to stimulate thought and discussion about the nature of core concepts and their application to real-world settings. This edition has many more questions and exercises than earlier editions.
- *Numerical problems* Numerical problems are set out at the end of each chapter. These problems often require students to use material from earlier tables, graphs, or Headlines. Answers to all problems are provided in the *Instructor's Resource Manual* along with clarifying annotations.

- *End-of-text glossary* The chapter-specific definitions and key-term reviews are supplemented with a comprehensive glossary at the end of the text.
- *Web-based exercises* Up to four problems at the end of each chapter require students to retrieve and use material from specific websites. Answers and additional suggestions are contained in the *Instructor's Resource Manual*.
- *Living Econ* This new end-of-chapter feature gives students personal insights into how the economy relates to their everyday activities.

Contents: Microeconomics

The micro sequence of the text includes only six chapters. In this brief space students get an introduction to the essentials of consumer demand, producer supply decisions, market structure (competition versus monopoly), and labor market behavior. In each case the objective is to spotlight the essential elements of market behavior, for example, the utility-maximizing behavior of consumers, the profit-maximizing quest of producers, and the interactions of supply and demand in setting both wages and prices. The monopoly chapter (Chapter 7) offers a step-by-step comparison of competitive and monopoly behavior, in both the short and long run. Contrasts with centrally planned economies are also strewn throughout the discussion to highlight the unique character of *market* outcomes.

The final chapter in the micro core examines the purposes of government intervention. The principal sources of market failure (public goods, externalities, market power, inequity) are explained and illustrated. So, too, is the nature of government intervention and the potential for *government* failure. Students should end the micro core with a basic understanding of how markets work and when and why government intervention is sometimes necessary.

Contents: Macroeconomics

The macro sequence begins with a historical and descriptive introduction to the business cycle. The rest of the opening macro chapter explains and illustrates the nature and consequences of unemployment and inflation. This discussion is predicated on the conviction that students have to understand *why* business cycles are feared before they'll show any interest in the policy tools designed to tame the cycle. The standard measures of unemployment and inflation are explained, along with specific numerical goals set by Congress and the president.

The basic analytical framework of aggregate supply and aggregate demand (AS/AD) is introduced in Chapter 11. The focus is on how different shapes and shifts of AS and AD curves affect macro outcomes. The AS/AD framework is also used to illustrate the basic policy options that decision makers confront. The stylized model of the economy illustrated in Figure 11.1 (p. 252) is used repeatedly to show how different macro determinants affect macro outcomes (e.g., see the highlighting of fiscal policy in Figure 12.1 on p. 279).

The fiscal-policy chapter surveys the components of aggregate demand and shows how changes in government spending or taxes can alter macro equilibrium. The multiplier is illustrated in the AS/AD framework and the potential consequences for price inflation are discussed. The chapter ends with a discussion of budget deficits and surpluses.

The monetary dimensions of the macroeconomy get two chapters. The first introduces students to modern concepts of money and the process of deposit creation. Chapter 14 focuses on how the Federal Reserve regulates bank reserves and lending to influence macro outcomes.

Supply-side concerns are addressed in Chapter 15. The potential of tax cuts, deregulation, and other supply-side policy options to improve both short- and long-term macro performance is explored. The chapter also offers a discussion of why economic growth is desirable, despite mounting evidence of environmental degradation and excessive consumption.

The final chapter in the macro section is every student's favorite. It starts out with a brief review of the nature and potential uses of fiscal, monetary, and supply-side policy options. Then the economic record is examined to highlight the contrast between theory and reality. The rest of the chapter identifies the obstacles that prevent us from eliminating the business cycle in the real world. These obstacles include everything from faulty forecasts to pork-barrel politics.

Contents: International Perspective

No introduction to economics can omit discussion of the global economy. But how can international topics be included in such a brief survey? *Essentials* resolves this dilemma with a two-pronged approach. The major thrust is to integrate global perspectives throughout the text. Many of the Headline boxes feature international illustrations of core concepts. In addition, the basic contrast between market and command economies that sets the framework for Chapter 1 is referred to repeatedly in both the micro and macro sections. The U.S. economy is described in a global context (Chapter 2) and analyzed throughout as an open economy with substantial foreign trade and investment sectors. Students will not think of the U.S. economy in insular terms as they work through this text.

The second global dimension to this text is a separate chapter on international trade. Chapter 17 describes U.S. trade patterns, then it explains trade on the basis of comparative advantage. Consistent with the real-world focus of the text, a discussion of protectionist pressures and obstacles is also included. Exchange rate determinations are also explained, along with the special interests who favor currency appreciations and depreciations. The objective is to convey a sense not only of why trade is beneficial but also why trade issues are so politically sensitive.

Text Supplements

Study Guide

From the student's perspective, the most important text supplement is the *Study Guide*. The new *Study Guide* has been completely updated by Professor Linda Wilson (University of Texas at Arlington). The *Study Guide* develops quantitative skills and the use of economic terminology, and enhances critical thinking capabilities. 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.
- *Learning Objectives* The salient lessons of the text chapters are noted at the outset of each *Study Guide* chapter.

- *Using Key Terms* Students are asked to complete a crossword puzzle using key terms.
- *True-False Questions* Ten true-false questions are provided in each chapter.
- *Multiple-Choice Questions* Twenty multiple-choice questions per chapter are provided.
- *Problems and Applications* These exercises stress current issues and events and problem-solving techniques. Headline boxes are the focus of questions and problems.
- *Common Student Errors* The basis for common student errors is 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.

Instructor's Resource Manual

Prepared by Mark Maier of Glendale Community College in collaboration with Todd Easton of the University of Portland, the *Instructor's Resource Manual (IRM)* is designed to assist instructors as they cope with the demands of teaching a survey of economics in a single term. Each chapter of the *Instructor's Resource Manual* contains the following features:

- *NEW! What Is This Chapter All About* A brief summary of the chapter.
- *NEW! New to This Edition* A list of changes and updates to the chapter since the last edition.
- *Lecture Launchers* Designed to offer suggestions on how to launch specific topics in each chapter.
- *Common Student Errors* To integrate the lectures with the student *Study Guide*, this provides instructors with a brief description of some of the most common problems that students have when studying the material in each chapter.
- *Headlines* A list of Headlines from the text is provided for easy reference.
- *Annotated Outline* An annotated outline for each chapter can be used as lecture notes.
- *NEW! Structured Controversies* Chapter-related topics are provided for sparking small-group debates that require no additional reading. Also accessible on the website.
- *NEW! Mini-Debates* Additional chapter-related debate topics that require individual students to do outside research in preparation. Also accessible on the website.
- *NEW! Mini-Debate Projects* Seven projects are provided, cutting across all the chapters. These include several focus questions and outside research.
- *Answers to the Chapter Questions and Problems* The IRM provides answers to the end-of-chapter questions and problems in the text, along with explanations of how the answers were derived.
- *Answers to Web Activities* Answers to Web Activities from the textbook are provided in the IRM as well as on the website.
- *Print Media Exercise* Provides a ready-to-use homework assignment using current newspapers and/or periodicals to find articles that illustrate the specific issues.

Test Bank

The *Test Bank* to accompany *Essentials of Economics* follows the lead of the textbook in its application of economic concepts to worldwide economic issues, current real-world examples, and the role of government in the economy. The *Test Bank* has been prepared by Linda Wilson of the University of Texas at Arlington and Diane Keenan of Cerritos College. The *Test Bank* contains roughly 2,000 objective, predominantly multiple-choice questions. Each multiple-choice question is coded as to level of difficulty and is given a text-page reference where the student will find a discussion of the concept on which the question is based. Questions based on the boxed Headline material are segregated to facilitate their use. Approximately 600 questions are new or revised from the last edition.

PowerPoints

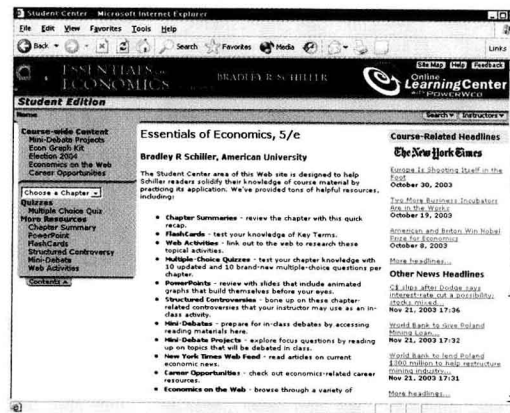
Anthony Zambelli of Cuyamaca College has prepared a comprehensive set of PowerPoint presentations to correspond with the fifth edition. These slides offer the rare opportunity to build animated graphs on-screen, so students see the importance of each step. Consisting of over 500 slides, the PowerPoints present the text's key graphs and illustrations along with lecture notes.

News Flashes

As up-to-date as *Essentials of Economics* is, it can't foretell the future. As the future becomes the present, however, I will write News Flashes describing major economic events and relating them to specific topics in the text. Four to six News Flashes are posted on our website each year (www.mhhe.com/economics/schilleressentials5).

www.mhhe.com/economics/schilleressentials5

With brand-new interactive content developed by Mark Maier of Glendale Community College, Todd Easton of the University of Portland, and Jeffrey Phillips of Morrisville State College, the 5th edition website offers



Students have easy access to Chapter Summaries, Key Terms, PowerPoints, a *New York Times* Web Feed, and the following features that include brand-new content:

- Self-quizzes—Now 20 multiple-choice questions per chapter (10 are new!), with a self-grading function that allows students to see results and e-mail them to the professor

- *Using Key Terms* Students are asked to complete a crossword puzzle using key terms.
- *True-False Questions* Ten true-false questions are provided in each chapter.
- *Multiple-Choice Questions* Twenty multiple-choice questions per chapter are provided.
- *Problems and Applications* These exercises stress current issues and events and problem-solving techniques. Headline boxes are the focus of questions and problems.
- *Common Student Errors* The basis for common student errors is explained, along with the correct principles. This unique feature is very effective in helping students discover their own mistakes.
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- *Print Media Exercise* Provides a ready-to-use homework assignment using current newspapers and/or periodicals to find articles that illustrate the specific issues.

- **NEW!** In-Class Debates
- **NEW!** Extending the Debate—For in-class debates, including additional reading
- **NEW!** Debate Projects—Seven projects that provide focus questions and require outside research.

Instructors also have online access to the Instructor's Manual, PowerPoint slides, and helpful grading resources for the Web Activities, Structured Controversies, Mini-Debates, and Mini-Debate Projects.

Acknowledgments

Users of the first four editions have been generous in sharing their experiences and offering suggestions for revision. In addition, the fifth edition benefited from very detailed reviews provided by:

Sue Bartlett, *University of South Florida*
John Bockino, *Suffolk Community College*
Rob Catlett, *Emporia State University*
Bruce Christopherson, *Bellevue Community College*
Mark Friedman, *Minnesota State University—Mankato*
Arlene Geiger, *CUNY—John Jay College of Criminal Justice*
Perry Haan, *Hondros College*
Robert Harmel, *Midwestern State University*
Syed Hussain, *University of Wisconsin—Oshkosh*
Judy Kamm, *Lindenwood University*
Felix B. Kwan, *Maryville University in St. Louis*
Linda M. Kwiatkowski, *Hondros College*
Judy Lee, *Leeward Community College*
Kjartan T. Magnusson, *Salt Lake Community College*
Earl L. Martin, Jr., *Hondros College*
Gayle A. Morris, *Edinboro University of Pennsylvania*
Sunday C. Nzeako, *CUNY—John Jay College of Criminal Justice*
Z. Edward O'Relley, *North Dakota State University*
Janet Ratliff, *Morehead State University*
Robert C. Rencher, Jr., *Liberty University*
Barbara Ross-Pfeiffer, *Kapi'olani Community College*
Gerald Smith, *Minnesota State University—Mankato*
Kenneth A. Small, *University of California at Irvine*
Laura Sosa, *Mercer County Community College*
Wendy Stock, *Montana State University*
Charles Wilf, *Duquesne University*

At McGraw-Hill, I was fortunate to have Katie Crouch as my development editor once again and Kari Geltemeyer as my able project manager. Together they kept all the pieces together as the book and supplements worked their way through the production process. Jon Vaupel provided critical and timely research assistance. Thanks are also due to Martin Quinn, my marketing director, for personal and corporate support of McGraw-Hill's sales efforts.

Last, but far from least, I have continued to benefit from the advice and support of Paul Shensa, my on-and-off editor of 30 years.

Final Thoughts

Hopefully, the brevity, content, style, and novel supplements of *Essentials* will induce you to try it out in your introductory survey course. The ultimate measure of the book's success will be reflected in student motivation and learning. As the author, I would appreciate hearing how well *Essentials* lives up to that standard.

Bradley R. Schiller