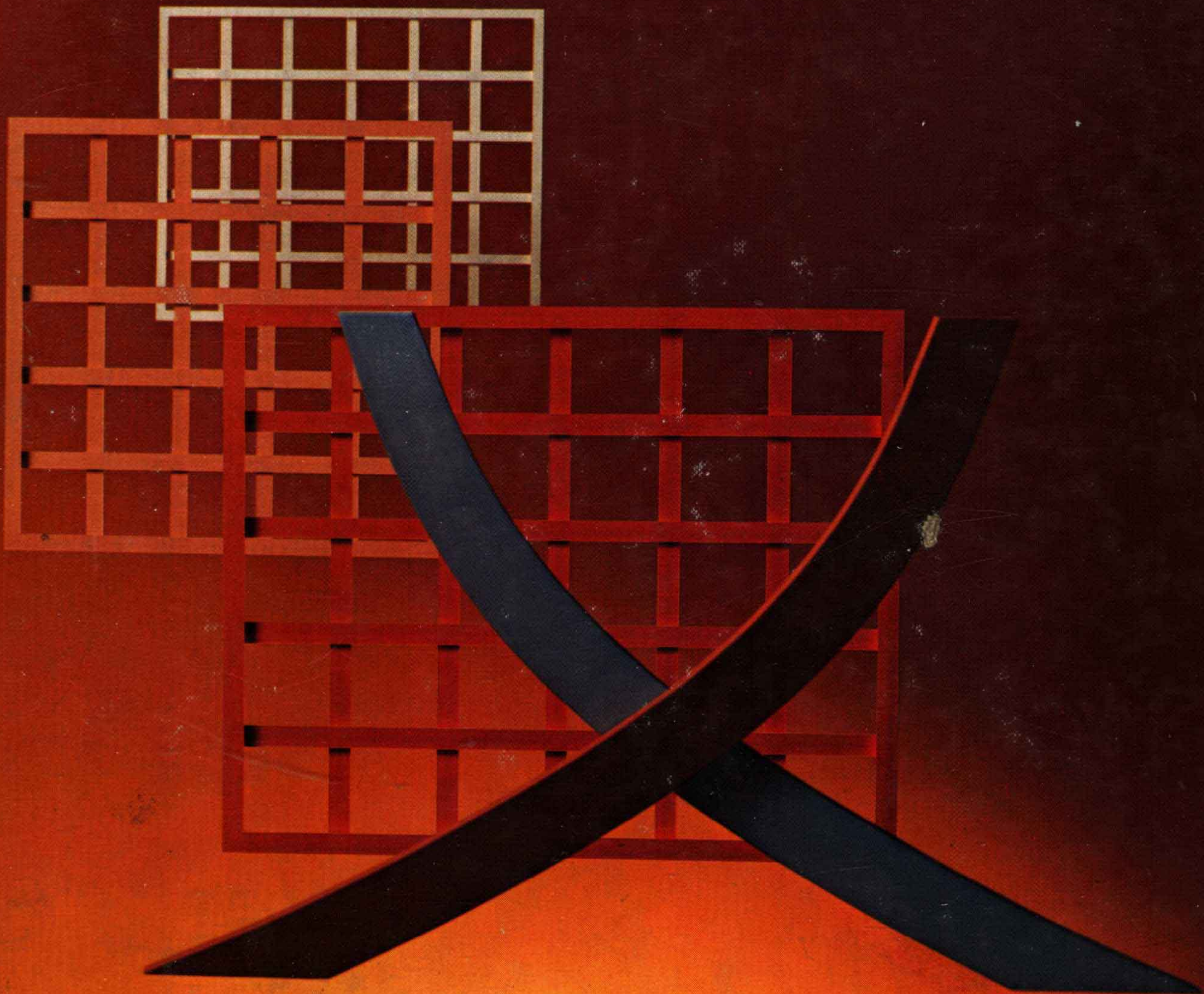
ECONOMICS

Wonnacott / Wonnacott

Second Edition



ECONOMICS

SECOND EDITION

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Suggested Outline for a One-Semester Course

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

Preface

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

Perhaps some day you will contribute to their solution.

HOW TO USE THIS BOOK

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

When you read a chapter for the first time, don't worry about what is in the boxes. This material is optional; it is set aside from the text to keep the main argument as simple and straightforward as possible. (Several types of material are presented in the boxes. Some boxes provide levity or color—for example, Kurt Vonnegut's tale on p. 781 of the Handicapper-General whose aim is to ensure that people will not only start out equal but also finish that way. Other boxes present detailed theoretical explanations; they are not needed to grasp the main argument.) If you want to glance at the boxes that are fun and easy to read, fine. But when you first read a chapter, don't worry about those that contain more difficult material. On the first reading, you may also skip starred (*) sections of the text, along with the footnotes and appendixes; these also tend to be more difficult. Come back to them later, after you have mastered the basic ideas. And listen to your instructor, who will tell you which of the boxes and starred sections are most important for your course.

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

TO THE INSTRUCTOR

In the second edition, there are four new chapters:

Chapter 14. How does the economy adjust to inflation? The standard argument—that steady, predictable inflation will have little effect on real economic magnitudes—is explained. We also emphasize the assumptions needed to reach this conclusion. And we explain the ways in which the assumptions are not fulfilled, with the result that inflation has substantial, continuing real effects. Many of these effects are attributable to the tax system. The combination of inflation and taxes distorts financial markets and investment, complicates business decision making, and makes it extremely difficult for young people to buy their first homes. Legislation passed in the summer of 1981—which will index tax brackets beginning in 1985—will end the "tax bracket creep" which has pushed people into higher marginal tax brackets as a result of inflation. But the distortion in capital markets resulting from the inflation-taxation combination will remain.

Chapter 17. Why have productivity and growth been so disappointing in recent years? Denison's research is the starting point for considering this question. The problem is that Denison's explanations don't explain most of the slowdown in productivity performance; his research leaves a large unexplained residual. We look at possible explanations for this residual. For example, Denison may have underestimated the effect of the rising price of oil. This chapter also presents a description and critical evaluation of "supply-side" economics.

Chapter 25, on regulation. When is regulation in the interests of the firms being regulated, and when is it not? Was there too much regulation during the 1970s? Is there a risk of an overreaction? May there be too little regulation during the 1980s?

Chapter 34, on energy. This chapter studies energy policy, in the light of the conflict between efficiency and equity. In the face of the rapid escalation of international oil prices, similar rises in the prices of domestic oil and its products were desirable from the viewpoint of efficiency. But it was generally considered unfair to allow domestic oil prices to skyrocket, and thus provide oil producers with a bonanza at the expense of consumers. Consequently, a complex price control system was used during the 1970s. And the decontrol of oil prices was accompanied by a windfall profits tax. This chapter also discusses alternative sources of energy, including the environmental problems with some sources. (Oil prices appear not only in this chapter, but are also a recurring topic in this second edition.)

As we have added new material, we have continued to aim at the three major objectives we set in the first edition. The first two objectives grew out of questions that arose in our teaching—and out of our uneasiness regarding the answers.

For macroeconomics, the principal question was this: After studying introductory economics, are students able to understand public controversies over such topics as the level of government spending and taxation, the desirability of wage and price controls, and monetary policies? Are we training our students to understand the front pages of the newspaper? For many years, the introductory course was aimed at teaching students how policy should be run; that is, at providing a cookbook of "right" answers. While many books express more doubts and qualifications than was the case a decade ago, our course is focused even more strongly in this direction, as we build up to the seven controversial questions dealt with in the chapters of Part 3: Is fiscal or monetary policy the key to aggregate demand? How can inflation exist at the same time as a high rate of unemployment? How does the economy adjust to inflation, and what are the temporary and the lasting effects of inflation? To what extent should we attempt to "fine tune" the economy? Why is the economy unstable? Why have productivity and growth been so disappointing in recent years? Should exchange rates be fixed or flexible?

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

In addition to the two new macroeconomic chapters (14 and 17), this new edition covers a number of new macroeconomic topics; for example, the early budget proposals of the Reagan administration (in Chapters 5 and 17), the underground economy (Chapter 7), recent changes in banking legislation and banking institutions—including new interest-bearing checking deposits (Chapter 10), the pros and cons of price controls (Charlie Schultze vs. Walter Heller, in Chapter 13), and the theory of rational expectations (Chapter 16).

In addition to introducing new material, we have made numerous changes in response to users' suggestions. For example, in the exposition of Keynesian theory (Chapter 8), we have placed greater emphasis on the saving/investment approach, and integrated it more closely with the aggregate demand (consumption + investment) approach. [At the same time, we still introduce macroeconomic theory with aggregate demand and aggregate supply (pp. 141–153). Our experience has been that students are confused by an initial emphasis on saving and investment.] Detail has been added on the first step in the Keynesian explanation of monetary policy (Chapter 12). And there is an expanded explanation of the interaction between the multiplier and accelerator (Chapter 15).

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

At the same time, we have been able to go some distance in accommodating users' requests for additional analytic material. For example, we now introduce the chapter on costs and supply with the production function, showing how a firm uses it to calculate its costs curves as a step in finding its profit-maximizing output (Chapter 21). We believe that the economist's distinction between the long run and the short run is clarified by the presentation of the long-run production function table (p. 477), and the short-run production function as a row within this table. (A discussion of production isoquants is provided in the Appendix to Chapter 21.) A new box in Chapter 21 describes the equilibrium of the firm using total cost and total revenue curves; but the emphasis in this chapter remains on marginal cost and marginal revenue. In addition, we now emphasize the importance of entry in determining the long-run supply curve, and the long-run response of a competitive market to changes in demand. (We now also emphasize the importance of labor mobility in Chapter 30.)

In the second edition, as in the first, we have attempted to make microeconomics more interesting by organizing our discussion around two continuing themes: ***efficiency*** and ***equity***. In Part 4, our focus is on efficiency, and we accordingly emphasize marginal curves: For efficiency, equating marginal cost and marginal benefit is the key. And the study of marginal curves leads naturally to consumer surplus and producer surplus, which are building blocks for the study of income distribution and equity in Part 5.

In recent years, the topic of equity has increased in importance. At least until the beginning of the Reagan administration, the government has been redistributing an increasing percentage of income as our national income has grown. The discussion of income redistribution leads us to one of the most interesting—but discouraging—recent developments in microeconomics. For years, many economists regarded the negative income tax as a way of resolving the equity/efficiency conflict. However, extensive experimental evidence from Seattle and Denver has led observers to be far less optimistic—as we explain in Chapter 36.

The second edition also describes developments in the theory of public choice (Chapter 27). We consider the problem of the oppressive majority; logrolling (when it is in conflict with the public interest, and when it may actually promote it); and the theory of bureaus—why, in a world in which private monopolies may employ too few resources, public monopolies may employ too many.

Other new or greatly expanded topics in the second edition include Robert Coase's theory of property rights; the many roles of a union in addition to bargaining for higher wages; a more subtle and extensive discussion of the labor bargaining process and the reasons that strikes occur; and an expanded discussion of rent. (In Chapter 32, we now explicitly consider two reasons for rent: First, there may be differences in the productivity and incomes of factors in their present occupations; second, there may be differences in their productivity and incomes in their best alternative occupations—that is, there may be differences in their opportunity costs. Other introductory books typically examine one or the other source of rent, but not both.)

While making extensive revisions and updating, we have continued our three main objectives of the first edition: To provide an understanding of vexing *current policy issues* in the macro chapters; to provide coherence and interest to the micro chapters by focusing on the major themes of *efficiency* and *equity*; and to make the exposition proceed in *small, orderly steps*.

LOOKING AHEAD

Because we have attempted to make the discussion build up in orderly steps, we recommend that teachers look ahead to later passages before introducing certain subjects. Specifically:

Before introducing the concept of the potential GNP path, instructors should look ahead to pages 356–360. The potential GNP path is a useful concept, but substantial difficulties have arisen in estimating the path during the 1970s. These difficulties have important consequences for macroeconomic policy (making it difficult to identify the appropriate GNP target). We have found that students find these problems both interesting and understandable, and have therefore discussed them on pp. 356-360. By reading these pages before introducing the concept of full-employment or potential output, the instructor is in a better position to answer classroom questions, and, where appropriate, to note that qualifications will be introduced later.

We recommend that instructors who wish

to teach indifference curves read not only the first indifference curve appendix (in Chapter 20), but also the second (in Chapter 22) before introducing this topic to their classes. In the second appendix, we consider a topic not found frequently in elementary tests; namely, how indifference curves can be used to illustrate the way in which a perfectly competitive economy results in an efficient allocation of resources. Students find this an interesting topic. And this use of indifference curves fits directly into our emphasis on efficiency throughout Part 4 of this book. In discussing the first indifference curve appendix, the instructor will be in a better position to lay the basis for the later discussion by looking ahead to the second appendix.

The central theme of Part 4—economic efficiency—is laid out in Chapter 22. In order to prepare the groundwork for this chapter, we would recommend that instructors read it before beginning to teach Part 4.

OTHER POINTS OF INTEREST

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

● In emphasizing efficiency and the gains from specialization, we have given greater attention to economies of scale than is frequently the case. In Chapters 3 and 28, economies of scale are given billing almost equal to comparative advantage. In our opinion, economies of scale are an important source of gain from specialization, and they should not be avoided because of the difficult analytic problems to which they lead. (Most of the analytic problems can be avoided in an introductory text.)

● We consider the problem of financial instability in more detail than most other books. (For example, see the discussion of bankruptcies during recessions in Box 15-2, and the discussion of the Hunts' silver escapade on p. 232.) In our opinion, the "Keynesian revolution" resulted in too little attention to money as a source of macroeconomic disturbance (a deficiency which has been corrected —perhaps overcorrected—in the current literature), and it also resulted in inadequate attention to the financial side of the economy (a deficiency which has not been corrected).

● We discuss the gold standard—and the problems which it raises—in more detail than most other books (pp. 235–239). This topic is important for an understanding of history, particularly the problem of bank instability. Many students are fascinated by it. And there has been a resurgence of interest in the gold standard, in large part because of the intractability of inflation. Like most economists, we oppose the return to the gold standard (particularly in its classical version, with the quantity of money determined by the quantity of gold). But we also believe it is important that students of economics know *why.*

● Because of our emphasis on major themes and problems, our discussion of international economics is organized differently than in most books. The gains from trade and the effects of protection fit into the topic of efficiency, and therefore they are included in Part 4 (Chapters 28 and 29). But exchange rate arrangements are most closely related to such issues as inflation and unemployment, and they are therefore included with other macroeconomic topics (in Chapter 18). By keeping international topics next to related domestic topics, we hope to counteract the neglect of international economics in many introductory courses.

● Students are introduced to the important idea of dynamic efficiency. Any detailed analysis of dynamic efficiency has traditionally been regarded as too difficult for an elementary course. Initially we sympathized with this view, until we discovered that most beginning students *can* handle a problem like the most efficient pattern of resource use over time (optional Box 33-3).

● We show how conflicts can exist not only between objectives (such as equity and efficiency), but also between groups of people in the economy. For example: The theory of comparative advantage illustrates how foreign trade can increase a nation's real income. We go one step further, to emphasize how trade affects various groups differently. Low-cost imports benefit consumers, but they hurt competing domestic producers. It is easy for students to identify such winners and losers. They thereby can appreciate the irony of complaints about agricultural price supports from business executives who benefit from tariffs that prop up the prices of the goods *they* produce. Moreover, this identification of different groups (and the differences in their political power) helps the student to answer one of the basic questions raised by the theory of public choice: Why is there a difference between what the government *should* do, and what it *does* do?

●Other topics on which we have placed more than usual emphasis include externalities (Chapters 26 and 27), and the difficulty of policy making when we face both a high rate of unemployment and high inflation (Chapter 13).

ALTERNATIVE COURSE DESIGNS

As already noted, some of the boxes in the text are used to introduce material that may be too difficult for some students, but highly enlightening for others. (See, for example, Box 22-2 on Pareto efficiency and Box 23-1 on the theory of the second best.) We hope that these boxes, along with similarly designed appendixes, will give you flexibility in designing your course.

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

We wish to thank. . .

In developing this second edition, we have shamelessly accumulated intellectual debts to our colleagues and coworkers. Special thanks go to the editing and production staffs of McGraw-Hill. In particular we should like to thank our editor, Mike Elia. We remain in debt to those who helped in the development of the first edition, particularly Lloyd C. Atkinson of the Congressional Budget Office, Heidemarie C. Sherman and Allen R. Thompson of the University of New Hampshire, and Frank D. Tinari of Seton Hall University. The great many suggestions we received during the preparation of the second edition are acknowledged on the following pages. To all, we express our deepest thanks.

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