

PRINCIPLES OF ECONOMICS



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University of Illinois



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To my wife Diane

To my children, Lisa and Joshua,
who grew up together, not just as
sister and brother, but as best friends



PREFACE

At the end of fall semester a few years ago, I told my class of 1,000 Economics 101 students that I wanted to see how much of the course they would be able to recall four months after the final exam. I asked them to take a post-final exam in early April, covering the same material. A few hundred showed up to take the April exam. The results were instructive, and perhaps not too surprising.

These were very bright students. The scholastic entrance requirements to the University of Illinois are quite high. During the semester, they were able to handle the math and graphs without difficulty. Yet, when it came to the April exam—only four months after the final—there was much confusion explaining, and even more graphing, market equilibrium, national income determination, and other basic ideas.

If I ever thought that the analysis offered in lectures and in the textbook is what students really ingest during the semester, that thought was very quickly dispelled.

Why is the half-life of what we teach so short? Are we trying to teach too much? *Is our basic principles course getting away from being an analysis of basic principles?* Have we forgotten that there is an opportunity cost every time we add material to a course or textbook? Are our textbooks more plumbers' manuals on technique than analyses of a social science subject? What do we want our students to know? Can we talk to our students and be heard?

I wrote this textbook with these questions in mind. It is written for the student, not for the professor. These are two very different readers. To my surprise, I found it difficult to keep the focus on the student who comes to the material without prior knowledge. It was much easier to write to the professor. Most of my rewriting had to do with correcting the focus. Much of the differences in style, content, and depth of analysis between my text and the others on the market reflects this focus. My preference was to sacrifice the number of topics for depth and to present the basics in as nonthreatening a style as possible.

A major problem I confronted in every chapter was what material to exclude while still covering the basic principles with analytic rigor. I chose to challenge the student holding a yellow highlighter. If I could get that student to read without highlighting, perhaps I could light a fire in the student's mind. This book is my answer to that challenge.

MICROECONOMIC ANALYSIS

How do you make fixed and variable costs seem important so that students see the connection between these costs and their own personal experiences? Perhaps by engaging them directly in the world of economic enterprise. In this book, students become the focus of economic activity. I ask them to consider setting up a business, making each of them a decision maker who purchases factors of production, chooses the scale of production, worries about prices, and determines how to calculate profit and loss. In this way, the economic concepts emerge naturally and take on a very real meaning.

The Use of Continuing Scenarios

The microeconomics chapters maintain a continuing storyline. I put the student on an island economy where fish is the staple food and commercial fishing a commonplace economic activity. The student sets up and runs a fishing firm. Fishing is something students can easily visualize and imagine themselves doing. The technology involved is relatively uncomplicated and the product—fish—is familiar and about as close to a homogeneous product as there is. The competition that takes place in the fish market, with price responding to changes in demand and supply, is also very immediate.

The fishing scenario anchors the chapter on supply and demand and several chapters that follow. It is used in analyzing price controls, appears in Chapter 7 on business organization, is the centerpiece in Chapter 8 on costs of production, and appears later in Chapter 9 on maximizing profit. Using this format, the economic concepts build on each other.

In the chapters on price determination, the analysis shifts to the ice-making industry (ice is used by the fishing industry). The student, still in the fishing world of earlier chapters, sees the ice-making firm first as a monopoly. Then, as more firms enter with product differentiation, the monopoly dissolves into monopolistic competition, and finally into perfect competition. In the chapters on factor pricing, the setting changes completely to the coal mining industry in Harlan County, Kentucky. The same coal mining scenario appears in Chapter 15 on wage determination under competitive conditions, in Chapter 16 on monopsony and unions, and finally in Chapter 18 on interest rate determination.

Teaching the $MC = MR$ Rule

The importance of the profit maximization rule of $MC = MR$ cannot be overstated. In most texts, this paramount idea first appears in the context of price determination in perfect competition. It reappears again in each of the market structure chapters. I was never happy with this traditional approach. Why? It forces students to fight their way through to $P = MR = MC = ATC$, while simultaneously trying to grasp marginal revenue analysis and digest the significance of the $MC = MR$ rule. That may seem like a reasonable enough exercise to professors. However, to beginning students and nonmajors—who were probably warned through the grapevine that economics is difficult and boring—this presentation of the material may be ample confirmation. I think there is a better way to introduce one of the most important ideas we teach in micro theory.

In this book, a complete chapter—Maximizing Profit—is devoted to the idea. This chapter appears before we discuss the intricacies of market structures and price determination. Profit maximization is followed by Chapter 10, Identifying Markets and Market Structures, which examines the outstanding characteristics of each market structure. This allows for an early comparison of market structures. The stage is then set for price determination in each market *which is done in one chapter*. With the $MC = MR$ rule already thoroughly developed and the various markets described, $MC = MR$ is both the organizing principle of the chapter and the universally applied rule. Price analysis focuses on this one central idea.

This approach is not only logical, but even more important, makes it easier for students to understand and retain the principles. Incidentally, I begin price determination in Chapter 11 with monopoly, then move to monopolistic competition, and conclude with perfect competition. Because students are already familiar with the downward-sloping demand curve (from Chapter 3 on supply and demand), I can show its connection to monopoly pricing. Then, I can explain why the demand curve becomes flatter as more firms enter the market. This leads to a discussion of monopolistic competition and finally to perfect elasticity in perfect competition. In this way, I avoid throwing a horizontal demand curve right at them from out of nowhere.

MACROECONOMIC ANALYSIS

Students already have a fair idea of what the macro issues are. Almost every media source comments daily on inflation, the Fed, budget deficits, unemployment, business cycles, and economic growth. Students know that economics affects their lives and they come into the course with strong interest. Our job is to link their lives to the body of economic thought we offer.

Like most texts, this one employs three basic models: aggregate demand and aggregate supply, the Keynesian cross, and variations on the Phillips curve. In each of the theory chapters, the policy issues are never out of reach. In fact, I typically discuss policy before theory. This is an attempt to make students appreciate why we get involved with theory in the first place.

Building the Blocks to Policy Analysis

The same policy issues keep reappearing throughout the macro chapters. I try to avoid pigeonholing ideas into chapter sections and just leaving them there. For

example, I introduce the problems of inflation and unemployment early in the first macro chapter to explain why we develop the simple aggregate demand/aggregate supply model. The chapter ends with a section: Can We Avoid Unemployment and Inflation? From the beginning, students know how the basic issues are linked to theory.

The same ideas are recast in the Keynesian model. Fiscal policy is not confined to one chapter, but keeps reappearing, each time presenting yet a new dimension. For example, in the core chapter on fiscal policy the inflationary and recessionary gaps developed in an earlier chapter are reintroduced, but now the question of budget balance is added to the discussion. Fiscal policy shows up again in the chapter on economic growth and business cycles, where it is seen as an instrument to moderate cycles. It reappears in the coverage of the Phillips curve, in the context of the debate on what government can or cannot do.

The money chapters—Money; Money Creation and Banking Policy; The Federal Reserve; and Monetary Policy—approach theory and policy in much the same way, staying close to basic principles. I sacrificed detailed discussion of current debates on target instruments (although they are mentioned). I felt such “up-to-date” discussion didn’t really add much to an understanding of how the Fed works or why it does what it does. I want the students’ energies directed to understanding the basic principles.

Student Focus Remains in Macro

Perhaps the most distinguishing feature in the macro chapters is the personal involvement of the student. This involvement runs through every macro page. Let me cite just one example that involves the question of how to measure unemployment. The student is presented with some hypothetical data and asked to estimate a rate of unemployment. The student has to think about whether to include the discouraged worker, the underemployed, and the frictionally, structurally, and cyclically unemployed. Each inclusion, of course, produces a different unemployment rate. When we finally get to the official BLS rate, the student knows that it is not some divinely inspired idea but a concept we create ourselves to give us meaningful information. They also know what is left out, and why.

In developing the Keynesian theory of income determination, I recast aggregate expenditures ($C + I$) and aggregate production ($C + S$). The focus of discussion is on what consumers do with their incomes ($C + S$) at various levels of income compared to what producers do (producing $C + I$) at these same income levels. This way of analyzing national income determination splits aggregate expenditures: the consumption spending in aggregate expenditures is the C of the consumers’ $C + S$ while the investment spending in aggregate expenditures is the I of the producers’ $C + I$. Why do this? Because focusing on the behavior of the consumers and producers personalizes the analysis. It makes it easier for the student to identify the problem of macro disequilibrium. Also, the student can put him- or herself in the shoes of the consumer and the producer and walk through the discussion personally.

Bringing in the Government

The text first presents macro theory in an economy without a government or foreign sector. This simplifies the analysis. The fewer the variables, the easier it

is for the student to follow the story. Understanding how national income equilibrium is arrived at is our principal goal. Government comes into the picture later when problems of unemployment and inflation are considered. But that's only the beginning.

My treatment of government is quite different from most texts. Throughout my theory and policy chapters, the focus is on fiscal policy. G 's and T 's are employed as if that's all there is to government. That makes sense when our aim is to develop the principles of policy, but it obscures a complete picture of government's role in the economy.

I have found precious few texts that make an effort to explain what government really does. In most books, the descriptive analysis of the public sector is put up front, as part of an institutions chapter, with pie charts showing current government data. The sense of how government works in our economy is lost.

Students know that government is a dominant player in our economic life. If we are going to explain how government works, how can we ignore its very *raison d'être*? Students ought to know and discuss what the different levels of government actually do. They ought to know something about the history of government spending, how specific functions—education, defense, public assistance—grew over time. I think my chapter on government spending is a major plus. The detailed analysis of government spending leads directly to another chapter that discusses how government finances its spending. Here, taxes, government borrowing, and debt are examined. There is a conscious historical bent to these descriptive chapters. They allow the student to see what government does and to appreciate that we can't simply manipulate G 's and T 's as if they were just numbers in an economics board game.

Discussing the Business Cycle

What else is new? What's old is new. The chapter Economic Growth and Cycles analyzes the business cycle and the history of theories explaining it. I want the student to see how economists struggled, and still do, with the phenomenon of recurring cycles. The innovation cycle, the housing cycle, the war-induced cycle, the population boom cycle, and the multiplier/accelerator cycle are important because they attempt to explain the causes of economic instability. The student reads about these ideas in *U.S. News and World Report* and hears about them on the "CBS Evening News." Business cycle theory belongs in any discussion of economic dynamics. A little history of economic thought is helpful.

Dealing with Lack of Consensus

Many economists avoid macro theory because it is loaded with intellectual landmines. Different schools of thought present competing ideas on fundamentals of macro theory and contentiously challenge one another. To say there is a lack of consensus in macroeconomics is a gross understatement! But that shouldn't be a problem in teaching macroeconomics. Dissension brings engagement, excitement, and intellectual challenge. Economics is not an exact science and we should readily acknowledge that fact to our students. Contentiousness notwithstanding, the issues are real and important. It is our job to stimulate the intellectual nerve of the student. The text tries to present macroeconomics in this light.

THE TEXT'S STYLE

I have emphasized that this text was written for the student, not for the professor. This is a commitment I made to myself when I started the project years ago. If nothing else sets this textbook apart, this does. My idea has been to make economics exciting, to show its importance in our everyday business of life, and to get students to understand the economists' way of thinking. I tried always to keep the analysis within reach of students. Make it real, even personal. Allow them to enjoy the subject matter, not just to think about the coming exam.

We absorb ideas in many ways: through our heads, our hearts, and our innards. An idea that stirs you emotionally has staying power. If you can feel it in your bones, it becomes more than an intellectual exercise. I kept that in mind in every chapter and in every paragraph written. The style is intentionally conversational, but the discussion is always serious. If the story is really understood, it will be remembered. Economists have something to say. That's what my textbook is about.

USE OF PERSONAL NAMES

I believe that economics is about people. As you read through the chapters, you can't help but see many, many names that personalize the discussion. Claudia Preparata buys fish, Diane Pecknold inherits a tobacco farm, Charles Edwards owns a coal mine, Nick Rudd is in the ice-making business. These, along with over 90 more, are real people. They are all friends of my son Joshua who died in 1989, age 19, a victim of lymphoma. The textbook is my way of honoring Josh and honoring as well the beautiful people who were a part of his life.

THE TEXTBOOK'S ACCESSORIES

Study Guide

A Study Guide is the students' principal *reality check*. Do they really know the material? It must be not only student-friendly, but a companion piece that reflects the text's heart and soul. Too often, study guides are written by individuals whose connection to the text author is via e-mail. The study guide becomes generic. Not so here. David Wishart, professor of economics at Wittenberg University, who wrote the Study Guide, is not only a close friend but an outstanding teacher who began his teaching career working with me in the principles course at Illinois. We have worked on this project together for a long, long time. His Study Guide captures the spirit of the text, making it that much easier for students to use.

Instructor's Manual

An Instructor's Manual is the one private connection between the classroom instructor and the author. As the text author, I felt it was important to the instructor, particularly the first-time instructor, that I write the manual myself. The manual is a companion piece to the text. It provides ideas on how to ap-

proach each chapter, tips on how to present the chapter's material, and alternative illustrations that can be used to explain points of theory and policy. It also discusses how to turn student questions into teaching opportunities. In each chapter of the manual, the corresponding text chapter outline and its key terms are included for easy reference. The manual also provides detailed answers to the many questions that appear at the end of each chapter in the text.

Test Bank

The Test Bank that accompanies my text includes over 5,000 objective questions, including many that I have written myself. Robert Toutkoushian of the University of Minnesota assembled this test bank, which is available in both printed and computerized formats.

Student Software

In this age of computing, no text package would be complete without tutorial software. The software that accompanies this text will give students a different slant on the material and help draw them into the subject.

Other Supplements

A set of 150 acetate transparencies is available to adopters of the text. These transparencies were chosen to illustrate key ideas in the principles course. They were carefully prepared to ensure that they are legible when projected as overheads.

The same set of images is also available on PowerPoint slides for computer-assisted lecturing. These slides employ transitions that suggest relationships between ideas for maximum presentation impact.

One other ancillary item will be especially helpful to students. The Graphing Primer, prepared by Rob Toutkoushian, takes them step by step through the processes of interpreting, understanding, and creating graphs.

ACKNOWLEDGMENTS

I am grateful to many people for help and encouragement throughout the development of this textbook. Many came to the project in a strictly professional capacity; most ended up as good friends. I owe them more than they believe is their due. At the beginning, George Lobell was enthusiastic about the idea of the textbook and believed that it would make a difference in the profession. He read many chapters, stayed in close touch, and still does. I thank this textbook for introducing me to George. David Wishart was a dear friend before we started the project, and working together on this textbook added another dimension to our friendship. Tricia Nelson and Pat Wakeley were development editors whose skills improved earlier versions of this manuscript immensely. Jack Calhoun, South-Western's economics editor, sold me on the idea of the team concept of publishing. It was Dennis Hanseman, the development editor at South-Western, who saw the project to completion. Responding to Dennis was like taking prelims all over again. But he made it all work. I owe him much, and thank him for his patience and his friendship. Finally, Craig Ramsdell, Rebecca Roby, and

Laura Cleveland played major roles in translating my word-processed drafts and rough sketches into the pleasing book you hold in your hands.

During this book's long gestation period, I have benefited from the comments and suggestions of many reviewers. My heartfelt thanks go to the following economists. This book is much improved because of their efforts.

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Finally, I want to thank Peter Schran, my colleague and close friend at Illinois, whose advice always made sense although it sometimes took me a while to appreciate it. Also, to Mark Wohar, professor of economics at the University of Nebraska, Omaha (who assisted in my principles course during the early 1980s), thanks for the help on several chapters.

Fred Gottheil
University of Illinois

Farewell

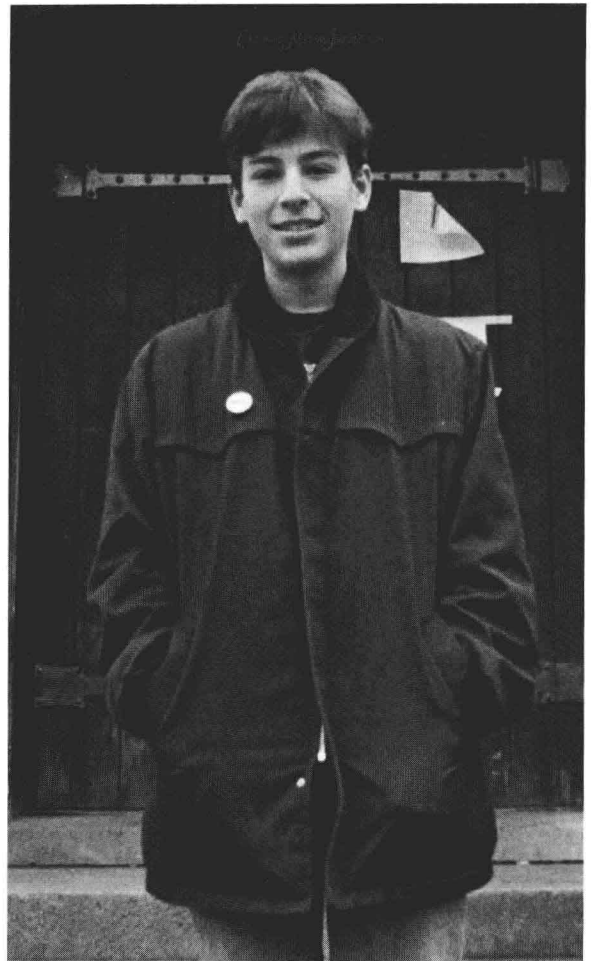
'His eyes would light up and he'd talk fast and you couldn't help being excited about the band or record he'd discovered, too.'

Part of being young is the feeling of being indestructible. Josh Gottheil, who died last month after a two-year battle against leukemia, probably understood that he wouldn't live forever. But he never stopped working to bring the music he loved to the world around him. Rock and roll would carry on.

The punk movement—simultaneously cynical and realist and suicidal and idealistic—tried in a frenzy to wipe out the commercialism and mass media hallucination which blurred life's realities, even unpleasant ones like death. There were bands named Dead Kennedys, Dead Milkmen, the prototype Dead Boys, and Gottheil's local band, Dead Relatives.

When he was only a sophomore in high school, Gottheil became a drummer for the short-lived band, but he was no angry punk. He heard the message in the music and he set out, ambitious at a tender age, to deliver it to the community.

At 17, he already had promoted dozens of concerts for teens in community centers and church foundations. He was the least pushy music promoter I ever met, enticing me to see at least one political rock and folk concert through his complete, quiet reticence.



News-Gazette file photo

It was the music that spoke to and through him.

At one concert he arranged, I watched Billy Bragg and Michelle Shocked get their introductions to the area. And I saw Josh, standing by the door at Mabel's, anxious to see that the message and the feeling came across.

His bands rarely disappointed.

Among the many other national bands he brought to Champaign's clubs were Living Colour, They Might Be Giants, Soul Asylum, Throwing Muses, Jane's Addiction, Dead Milkmen, Husker Du, Let's Active, Timbuk 3, Ministry, and the Pixies.

"The scene wouldn't be what it was today without Josh," said Chris Corpora, an area rock promoter of Trashcan Productions. "He didn't look the part and he risked his own money.

About four years ago he started teen nights when there was a lull in the scene. I don't want to deify him, but he had an incredible will, poise, and the wherewithal to get contracts signed and do things he probably shouldn't have been able to do. When I was 15, I couldn't even read a contract."

Even in the hard-core punk scene, Josh maintained a romantic side, often bringing roses for the girls in his favorite bands, notably Throwing Muses and the Pixies.

"He was always in love with every girl in a band," said Katy Spack, one of many people who considered Josh a best friend.

"He made friends with the Pixies and we flew to California to see them play in San Francisco," Spack said. "They invited him on stage to sing."

For a couple of summers, he worked at the desk at Crystal Lake Pool, announcing the adult swim and checking in bags. After high school, he took some college classes in philosophy and math at Parkland and at the UI, where his father, Fred, is a professor of economics. When he got sick, "it didn't look like he needed to go to college," according to Spack. "He was real busy doing all the music and he always had a lot of money. He was the only 16-year-old that had \$2,000 in his checking account."

Another friend, Shara Gingold, actually wrote a book about her crush on Josh.

"He was two years older. The book is called 'I Love You, Josh. Do You Even Know I Exist?'," said Gingold, who lives in Urbana. "I think that it was (the fact that) he was very understanding and caring. We'd meet to play tennis and then we'd just sit and hit the tennis ball against the wall and talk about everything."

Last year, his health started to improve. He gained weight. He was working at Record Swap, surrounding himself in music during the day for the concerts he promoted at night. He had teamed with Chicago promoter Tony Polous, established a limited partnership called Concert One Productions, rented an office in Chicago's Mercantile Building, and developed the financing for big arena shows.

"Josh was destined to be huge," said Polous from the Chicago office. "He was the most effective, easy-going person I ever met. It's not hard to master being pushy and strong. Josh mastered being effective in an unassuming way.

"When he had to go back to the hospital, he never let on how sick he was. Every day I'd call him and he'd ask about what this manager was doing or that agent and he'd make decisions. We never really talked about his health. I never thought he was going to die. I think about him every day."

Despite his illness, Josh moved to Chicago last fall to be immersed in the music business.

"It was a chance, a break, an exciting thing to do. The world was his to conquer," said Fred Gottheil from his UI office. "I remember going up to visit and spend the night. The wind was howling, but he was so proud of the apartment. He was designing tickets on his computer, telling me (about) all the bands he had booked, his new ideas, bubbling with enthusiasm for the possibilities. The move was exhilarating for him. He called home quite frequently, but (Chicago) was where he had to be."

Said former Champaign-Urbana DJ Charlie "The Quaker" Edwards, who shared the Chicago apartment, "He had a real vitality, youth, and infectiousness. His eyes would light up and he'd talk fast and you couldn't help being excited about the band or record he'd discovered, too. Even though there was almost 20 years age difference between us, we'd listen to albums and talk about the bands and share a mutual excitement.

"He was a really good, serious businessman. Much better than I could have been, always dealing with five shows at once. He really loved it, too. He just loved the music."

"Definitely, there are people who are into (punk) because it is a fad," Gottheil said three years ago. "But for the people who really believe in it, it won't die for them."

Josh Gottheil died April 4 at Barnes Hospital in St. Louis, three months short of his 20th birthday. There was a turn-away crowd for his funeral on April 7 at the Sinai Temple in Champaign. Because he did so much to bring a new attitude about music in this area, one of the bands he helped find national prominence, Throwing Muses, has donated its performance at a benefit concert this Sunday at Mabel's, with proceeds going to the Josh Gottheil Memorial Fund for Lymphoma Research.

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