

THE
HARPERCOLLINS
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OF

ECONOMICS

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Dr. Schwartz provided careful review of the original text of our dictionary and made many suggestions for new entries, deletion of inappropriate entries, and ways of achieving better balance of competing economic points of view. We hope that she will approve of the final form of the dictionary.

EUGENE EHRLICH
Series Editor

A

ability-to-pay principle of taxation the principle that TAXATION should be based on the financial standing of the individual. Thus, persons with high income are better able to pay, and should pay, larger amounts of tax than people on low incomes. In practice, the ability-to-pay approach has been adopted by most countries as the basis of their taxation systems (see PROGRESSIVE TAXATION). Unlike the BENEFITS-RECEIVED PRINCIPLE OF TAXATION, the ability-to-pay approach is compatible with the idea that such a system is just. However, a progressive tax, one based on ability to pay, may undermine incentive to work and invest. See REDISTRIBUTION-OF-INCOME PRINCIPLE OF TAXATION.

above-normal profit or **excess profit** a PROFIT greater than that which is just sufficient to ensure that a business will continue to supply its existing product or service (see NORMAL PROFIT). Short-term, that is, temporary above-normal profits resulting from an imbalance of market supply and demand promote an efficient allocation of resources if they encourage new companies to enter the market and increase market supply. By contrast, long-term, that is, persistent above-normal profits (MONOPOLY or *supernormal profits*) distort the RESOURCE ALLOCATION process because they reflect the overpricing of a product by monopoly suppliers protected by BARRIERS TO ENTRY. See PERFECT COMPETITION.

above the line promotional expenses associated with advertising.

absolute advantage an advantage possessed by a country when, using a given resource input, it is able to produce more output than other countries possessing the same resource input. This is illustrated in Fig. 1 with respect to two countries, A and B, and two goods, X and Y. Country A's resource input enables it to produce either 100X or 100Y; the same resource input in country B enables it to produce either 180X or 120Y. It can be seen that country B

ABSOLUTE CONCENTRATION MEASURE

is absolutely more efficient than country A since it can produce more of both goods. Superficially this suggests there is no basis for trade between the two countries. However, it is **COMPARATIVE ADVANTAGE** not absolute advantage, that determines whether **INTERNATIONAL TRADE** is beneficial, because even if country B is more efficient at producing both goods, it may pay country B to specialize (see **SPECIALIZATION**) in producing good X, at which it has the greater advantage.

Physical output of X and Y
from a given factor input

Country	Good	
	X	Y
A	100	100
B	180	120

FIG. 1. **Absolute advantage.** The relationship between resource input and output.

absolute concentration measure see **CONCENTRATION MEASURES**.

absolute value a mathematical term for the magnitude of a number, ignoring its sign. The absolute value of a positive number is the number itself; the absolute value of a negative number is the number without its minus sign.

In estimating **PRICE ELASTICITY OF DEMAND** for example, our interest is in the degree of responsiveness of quantity demanded to changes in price, and the fact that a price *increase* causes a *decrease* in quantity demanded and vice versa, giving a negative elasticity number, is of little interest. Here, taking the absolute value of the elasticity number is more appropriate.

accelerator the relationship between the amount of net or **INDUCED INVESTMENT** (gross investment less **REPLACEMENT INVESTMENT**) and the *rate of change* of **NATIONAL INCOME**. A rise in income and consumption spending will put pressure on existing capacity and encourage businesses to invest not only to replace existing capital goods as they wear out but also to invest in *new* plant and equipment to meet the increase in demand.

By way of simple illustration, let us suppose a business meets existing demand for its product by utilizing 10 machines, one of

ACCOUNTING PERIOD

which is replaced each year. If demand increases by 20%, the business must invest in two new machines to accommodate that demand, in addition to the one replacement machine.

Investment may be thought of, in part, as a function of changes in the level of income: $I = f(\Delta Y)$. A rise in induced investment, in turn, serves to reinforce the MULTIPLIER effect in increasing national income. A change in investment will induce a change in income and consumption and, therefore, a multiplied change in national income:

$$\uparrow \Delta I \rightarrow \uparrow \Delta Y \rightarrow \uparrow \Delta C \rightarrow \uparrow \Delta Y$$

The combined effect of accelerator and multiplier forces working through an *investment cycle* has been offered as an explanation for changes in level of economic activity associated with the BUSINESS CYCLE. Because the *level* of investment depends on the *rate of change* of GNP, when GNP is rising rapidly, investment will be at a high level as producers seek to add to their capacity (time t in Fig. 2). This high level of investment will add to AGGREGATE DEMAND and help maintain a high level of GNP. However, as the rate of growth of GNP slows down from time t onward, businesses will no longer need to add as rapidly to capacity, and investment will decline toward replacement investment levels. This lower level of investment will reduce aggregate demand and contribute to an eventual fall in GNP. Once GNP has persisted at a low level for some time, machines will gradually wear out and businesses will need to replace some of the machines in order to maintain sufficient production capacity to meet even the lower level of aggregate demand experienced. This increase in level of investment at time t_1 will increase aggregate demand and stimulate growth of GNP. See MULTIPLIER.

acceptance a bill of exchange that has been accepted by a bank or other financial institution on behalf of a client who may then use it to extend credit or to be extended credit.

accepting house a COMMERCIAL BANK or similar organization that underwrites (guarantees to honor) a commercial BILL OF EXCHANGE in return for a fee. See DISCOUNT, FACTORING.

accounting period the time period over which a business pre-

ACCOUNTS

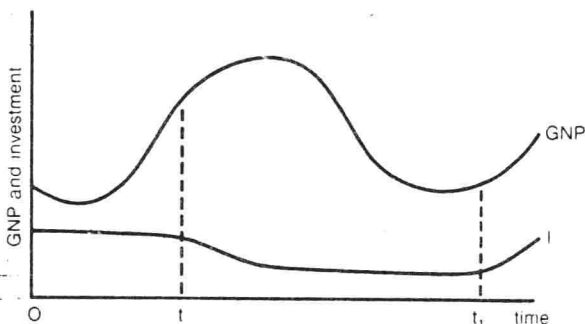


FIG. 2. **Accelerator.** The graph shows how gross national product and the level of investment vary over time. See entry.

prepares its financial statement and at the end of which it draws up its balance sheet. Corporations are required by law to prepare **ANNUAL REPORTS**, and most other companies do so as well. Many now prepare quarterly, monthly, or even weekly reports to give prompt information about performance.

accounts the financial statements of an individual or organization prepared from a system of recorded financial transactions. Public corporations are required to publish their year-end or period-end financial statements, which must comprise at least a financial statement and balance sheet, to enable shareholders to assess their company's financial performance during the period under review. **AUDITORS** also require a set of year-end or period-end accounts to enable them to undertake appropriate tests so as to form and submit their opinion on them to the company's stockholders. Nonincorporated bodies, such as sole proprietors and partnerships, are not subject to such rigorous internal constraints but must prepare appropriate financial statements to submit to the **INTERNAL REVENUE SERVICE** as a basis for tax assessments. See **LEDGER**.

accounts payable the money owed to individuals or companies because they have sold goods, services, or raw material for which they have not yet been paid or because they have made loans.

accounts receivable the money owed by individuals or companies because they have bought goods, services, or raw materials for

ADMINISTERED PRICE

which they have not yet paid or because they have borrowed money.

accruals principle of accounting the principle that all of a company's costs and revenues should be counted in its accounts from the date when the expenses are legally incurred and when the revenues are receivable, not when the expenses are actually paid or the cash is received.

actuary a statistician who calculates insurance risks and premiums. See RISK AND UNCERTAINTY, INSURANCE COMPANY.

adaptive expectations hypothesis (of inflation) the hypothesis that EXPECTATIONS of the future rate of INFLATION are based on the inflationary experience of the recent past. As a result, once under way, inflation is thought to feed on itself. For example, labor unions may demand an increase in wages during contract negotiations that takes into account the expected future rate of inflation. Such increases are thought, in turn, to lead to further price rises. See EXPECTATIONS-ADJUSTED/AUGMENTED PHILLIPS CURVE, INFLATIONARY SPIRAL.

adjustable peg system a form of FIXED EXCHANGE-RATE SYSTEM originally operated by the INTERNATIONAL MONETARY FUND, in which the EXCHANGE RATES between currencies are fixed (pegged) at particular values (for example, at the hypothetical rate \$3 = £1), but which can be changed to new fixed values should circumstances require it. For example, \$2 = £1, the repegging of the dollar at a higher value in terms of the pound (REVALUATION); or \$4 = £1, the repegging of the dollar at a lower value in terms of the pound (DEVALUATION).

adjustment mechanism a means of correcting imbalances in foreign payments. There are three main ways of removing payments, deficits, or surpluses: (a) external price adjustments, (b) internal price and income adjustments, and (c) trade and foreign-exchange restrictions. See BALANCE-OF-PAYMENTS EQUILIBRIUM.

administered price 1. a price for a PRODUCT that is set by an individual producer or group of producers. In PERFECT COMPETITION characterized by many producers, the price charged is determined by interaction of market demand and market supply, and the individual producer or buyer has no control over this price. By contrast, in an OLIGOPOLY and a MONOPOLY, the few

ADMINISTRATIVE COSTS

producers have considerable discretion over the prices they charge and can, for example, use some administrative formula such as **FULL-COST PRICING** to determine the price charged. A number of producers may combine to administer the price of a product by operating a **CARTEL** or price-fixing agreement.

2. a price for a product or **CURRENCY**, etc. that is set by the government or an international organization. For example, an individual government or **INTERNATIONAL COMMODITY AGREEMENT** may fix the prices of agricultural produce or commodities, such as coal, to support producers' incomes. Under an internationally managed **FIXED EXCHANGE-RATE SYSTEM**, member countries establish fixed values for the exchange rates of their currencies.

See **PRICE SUPPORT**, **PRICE CONTROLS**.

administrative costs the **COSTS** of maintaining an organization within which goods or services can be produced. They include salaries of managers, accounting, personnel, and secretarial staff; rent, heat, and light of the offices they occupy; and stationery, postage, and office equipment and furniture costs. See **OVERHEAD**.

administrative lag in setting monetary policy, the time between recognition that an action is needed and the taking of the action. The presence of lags makes the timing of monetary policy a hazardous process.

ad valorem tax a **TAX** levied as a percentage of price of a unit of output at the manufacturing, wholesale, or retail levels. The retail sales tax and value-added taxes common in Europe are ad valorem taxes.

advances see **LOANS**.

advertising a means of stimulating demand for a product and establishing **BRAND LOYALTY**. Advertising is one of the main forms of **PRODUCT DIFFERENTIATION** competition and is used both to inform prospective buyers of a brand's particular attributes and to persuade them that the brand is superior to competitors' offerings.

There are two contrasting views of the effect of advertising on **MARKET PERFORMANCE**.

Traditional, static market theory emphasizes the misallocative effects of advertising. Advertising is depicted as being solely concerned with brand-switching between competitors within a static

overall market demand and serving to increase total supply costs and the price paid by the consumer. This is depicted in Fig. 3a. (See PROFIT MAXIMIZATION).

The alternative view of advertising emphasizes its role as one of expanding market demand and ensuring that a company's demands are maintained at levels enabling it to achieve economies of large-scale production (see ECONOMIES OF SCALE). Thus, advertising may be associated with a higher market output and lower prices than allowed for in the static model. This is illustrated in Fig. 3b.

affirmative action employment rules set up or administered by local, state, and national governments that are intended to eliminate discrimination in labor markets and to offset the effects of previous, long-standing discrimination.

age-earnings profile the relationship between age and earnings. Typically, on leaving school, people will see their earnings increase rapidly, but the rate of increase diminishes as wage earners approach 40, from then on declining faster and faster. This profile reflects the accumulation of capital to provide for old age until, as old age approaches, wage earners save less and less and, at retirement, begin to use up accumulated savings.

agent an individual or business that acts on behalf of a client, for example, by buying or selling products or assets, or by representing a client's interests in a negotiation in return for a COMMISSION.

aggregate concentration see CONCENTRATION MEASURES.

aggregate demand or **aggregate expenditure** the total amount of expenditure (in nominal terms) on goods and services. In the CIRCULAR FLOW OF NATIONAL INCOME MODEL, aggregate demand is made up of CONSUMPTION expenditure (C) [see CONSUMPTION(1)], investment expenditure (I), GOVERNMENT EXPENDITURE (G), and net EXPORTS (exports less imports) (E):

$$\text{aggregate demand} = C + I + G + E$$

Some of the components of aggregate demand are relatively stable and change only slowly over time, for example, consumption expenditure. Others are much more volatile and change rap-

AGGREGATE DEMAND

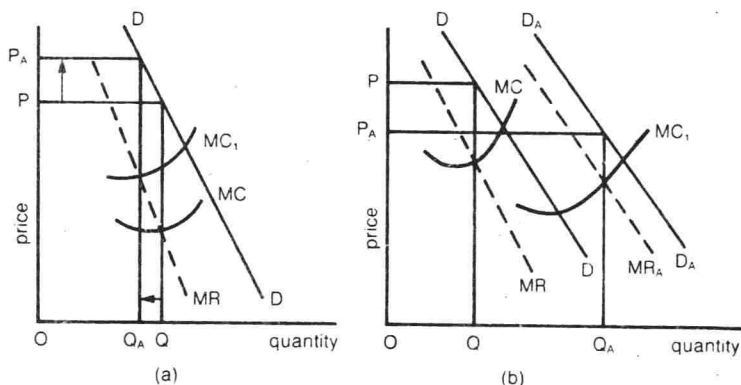


FIG. 3. **Advertising.** (a) The static market effects of advertising on demand (D). The profit maximizing (see PROFIT MAXIMIZATION) price-output combination (PQ) without advertising is shown by the intersection of the marginal revenue curve (MR) and the marginal cost curve (MC). By contrast, the addition of advertising costs serves to shift the marginal cost curve to MC_1 , so that the PQ combination (shown by the intersection of MR and MC_1) now results in higher price (P_A) and lower quantity supplied (Q_A). (b) The initial profit maximizing price-output combination (PQ) without advertising is shown by the intersection of the marginal revenue curve (MR) and the marginal cost curve (MC). The effect of advertising is to expand total market demand from DD to $D_A D_A$ with a new marginal revenue curve (MR_A). This expansion of market demand enables the industry to achieve economies of scale in production, more than offsetting the additional advertising cost. Hence, the marginal cost curve in the expanded market (MC_1) is lower than the original marginal cost curve. The new profit maximizing price-output combination, determined by the intersection at MR_A and MC_1 , results in a lower price (P_A) than before and a larger quantity supplied (Q_A). See BARRIERS TO ENTRY, MONOPOLISTIC COMPETITION, OLIGOPOLY, DISTRIBUTIVE EFFICIENCY.

AGGREGATE SUPPLY

idly, causing fluctuations in the level of economic activity, for example, investment expenditure.

Aggregate demand interacts with AGGREGATE SUPPLY to determine the EQUILIBRIUM LEVEL OF NATIONAL INCOME. Governments may seek to regulate the level of aggregate demand, and monetary authorities apply monetary policy, in order to maintain FULL EMPLOYMENT, avoid INFLATION, promote ECONOMIC GROWTH, and secure BALANCE-OF-PAYMENTS EQUILIBRIUM through use of FISCAL POLICY and MONETARY POLICY.

See AGGREGATE DEMAND SCHEDULE, DEFLATIONARY GAP, INFLATIONARY GAP, BUSINESS CYCLE, STABILIZATION POLICY.

aggregate demand/aggregate supply approach to national income determination see EQUILIBRIUM LEVEL OF NATIONAL INCOME.

aggregate demand schedule a schedule depicting total spending on goods and services at various levels of NATIONAL INCOME. It is constructed by adding together the CONSUMPTION, INVESTMENT, GOVERNMENT EXPENDITURE, and EXPORTS schedules, as indicated in Fig. 4a.

A given aggregate demand schedule is drawn up on the usual CETERIS PARIBUS conditions. It will shift upward or downward if the determining factor changes. See Fig. 4b.

aggregate expenditure see AGGREGATE DEMAND.

aggregate supply the total amount of domestic goods and services supplied by businesses and government, including consumer products and capital goods. Aggregate supply interacts with AGGREGATE DEMAND to determine the EQUILIBRIUM LEVEL OF NATIONAL INCOME (see AGGREGATE SUPPLY SCHEDULE).

In the short term, aggregate supply will tend to vary with the level of demand for goods and services, although the two need not correspond exactly. For example, businesses could supply more product than demanded in the short term, the difference showing up as a buildup of unsold STOCKS (unintended INVENTORY INVESTMENT). On the other hand, businesses could supply less product than demanded in the short term, the difference being met by running down stocks. However, discrepancies between aggregate supply and aggregate demand cannot be very large or persist for long, and businesses generally will only offer to supply output if they expect spending to be sufficient to sell all that output.

AGGREGATE SUPPLY

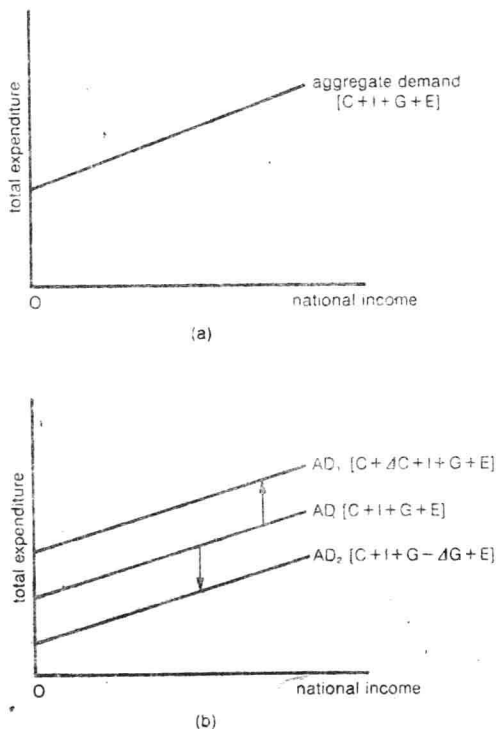


FIG. 4. Aggregate demand schedule. (a) The graph shows how AGGREGATE DEMAND varies with the level of NATIONAL INCOME. (b) Shifts in the schedule due to changes in determining factors. For example, if there is an increase in the PROPENSITY TO CONSUME, the consumption schedule will shift upward, serving to shift the aggregate demand schedule upward from AD to AD₁. A reduction in government spending, some economists believe, will shift the schedule downward from AD to AD₂.

In the long run, aggregate supply can increase as a result of increases in the size and quality of the labor force, increases in the quantity and quality of capital stock, and improvements in labor productivity.

See **POTENTIAL GROSS NATIONAL PRODUCT, ECONOMIC GROWTH.**

aggregate supply schedule a schedule depicting the total amount of domestic goods and services supplied by businesses at various levels of total expenditure. The **AGGREGATE SUPPLY** schedule is generally drawn as a 45° line, because businesses will offer any given level of national output only if they expect total spending (**AGGREGATE DEMAND**) to be just sufficient to sell all that output. Thus, in Fig. 5 \$100 million of expenditure calls forth \$100 million of aggregate supply, \$200 million of expenditure calls forth \$200 million of aggregate supply, and so on. This process cannot continue indefinitely, however, for once an economy's resources are fully employed in supplying products, additional expenditure cannot be met from additional domestic resources because the potential output ceiling of the economy has been reached. Consequently, beyond the full employment level of national product, Y_f , the aggregate supply schedule becomes vertical. See **POTENTIAL GROSS NATIONAL PRODUCT.**

Aggregate supply interacts with aggregate demand to determine the **EQUILIBRIUM LEVEL OF NATIONAL INCOME.**

aggregation problem the problem of deriving predictable macroeconomic behavior from the behavior of the underlying microeconomic units. In short, can all firms be lumped together as if, in their investment decisions, they were concerned with a single good called capital? Analytic use of such aggregates as capital, labor, and investment as though the production side of the economy could be treated as a single firm is a problematic procedure. Notwithstanding, macroeconomists continue to use such aggregates.

agricultural policy a policy concerned both with protecting the economic interests of the agricultural community by subsidizing farm prices and incomes, and with promoting greater efficiency by encouraging farm consolidation and mechanization. See Fig. 6.

The rationale for supporting agriculture partly reflects the spe-

AGRICULTURAL POLICY

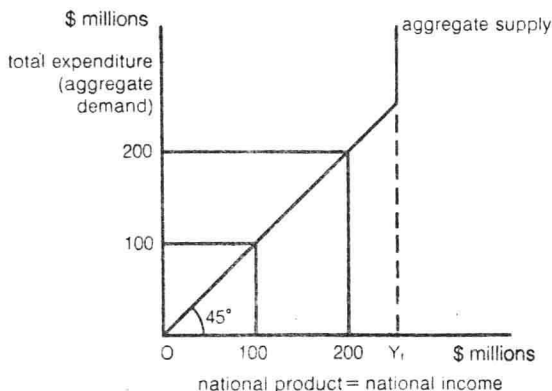


FIG. 5. Aggregate supply schedule. See entry.

cial nature of the industry itself: agriculture, unlike manufacturing, is assumed to be especially vulnerable to events outside its immediate control. Supply tends to fluctuate erratically from year to year, depending on such vagaries as weather, attack by insects, and disease (S_1 , S_2 , and S_3 in Fig. 6a), causing wide changes in farm prices and farm incomes. Over the long term, while the demand for many basic foods and animal produce has grown only slowly (from DD to $D_1 D_1$ in Fig. 6b), significant PRODUCTIVITY improvements associated with farm mechanization, chemical fertilizers, pesticides, etc. have tended to increase supply at a faster rate than demand (from SS to $S_1 S_1$ in Fig. 6b), causing farm prices and incomes to fall.

Farming can thus be a hit-and-miss affair, and governments concerned with the impact of changes in food supplies and prices (on, for example, the level of farm incomes, the balance of payments, and inflation rates) may well feel the need to regulate the situation. But there are also social and political factors at work, for example, the desire to preserve rural communities and the fact that even in some advanced industrial countries, for example, the European Community and the United States (since all 50 states have two senators each), the agricultural sector often commands

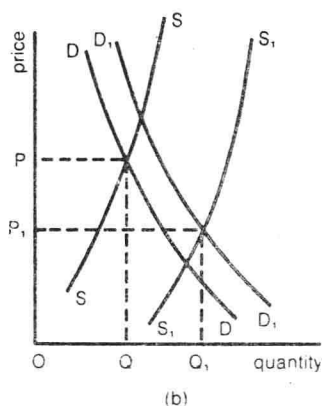
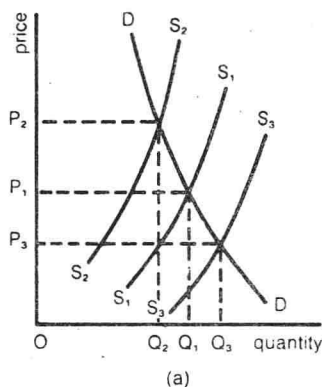


FIG. 6. **Agricultural policy.** (a) The short-term shifts in supply (S) and their effects on price (P) and quantity (Q). (b) Long-term shifts caused by the influence of productivity improvement on supply.

a political vote out of all proportion to its economic weight. Governments cannot be indifferent to the possibility of an inadequate domestic food supply. For this reason, subsidies to food producers and food retailers are common. See ENGEL'S LAW, COBWEB THEOREM, PRICE SUPPORT, INCOME SUPPORT.