



DEMYSTIFYING ECONOMICS

*The Book That Makes Economics
Accessible to Everyone*

Expanded Second Edition

Allen W. Smith, Ph.D.

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(Special Printing with Onlay Textbook Binding)

Allen W. Smith, Ph.D.

Professor Emeritus Eastern Illinois University

IRONWOOD PUBLICATIONS
Naples, Florida

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*For my wife,
Joan Rugel Smith*

and

*my children,
Mark, Michael, and Lisa*

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PREFACE

I didn't know what the subject was called at the time, but my interest in economics started when I was a small child growing up on an Indiana farm. I wondered about many things during those early years. Why did some people have so much more than others? How did one born into poverty pull oneself out of poverty and experience a more prosperous life? Why were grain and livestock prices so much higher in some years than in others? I had a lot of questions about life in those days, and now I realize that most of my questions were also about economics.

I graduated from a tiny rural high school with thirteen students in my graduating class and got a job in a local factory that manufactured overhead garage doors. When I got laid off about three months later, because of the seasonal nature of the industry, I took a job with a local farmer picking tomatoes alongside migrant farm workers. We got paid ten cents per basket of tomatoes picked, and the most I could pick in a long day was 100 baskets.

After a year of working for others, I entered farming on my own. I managed to borrow the money to buy enough junk machinery to farm a rented 230-acre farm. After four years of farming, a man suggested to me one day that maybe I should consider going to college. I considered it and decided that he was right.

After graduation from Ball State University, I taught high school social studies for two years before entering

graduate school to study economics. I had been formally introduced to the subject as an undergraduate, and it soon became clear to me that the study of economics was, to a large degree, the study of life. I was fascinated with the subject and spent four years at Indiana University earning a Ph.D. in the field.

For the next 28 years, I taught economics at Eastern Illinois University. It was a labor of love, but it also raised many concerns in my mind. I observed economic illiteracy firsthand, both in the classroom and in the community.

Finally, in 1975, I decided to try my hand at simplifying economics and wrote a book entitled, *Understanding Inflation and Unemployment*, which was chosen as an alternate selection of Fortune Book Club. Ten years later, I wrote a high school textbook entitled *Understanding Economics* which was published by Random House. *Understanding Economics* was well received and was used in more than 600 high schools in 48 states. Although I didn't see it coming, I would soon be hit by one of the biggest lessons in economics that I had ever experienced.

Almost every industry experienced "merger mania" during this period, with firms aggressively buying out other firms, sometimes through hostile takeovers. And mergers between firms resulted in a consolidation of market power into the hands of a few corporate giants. Random House's textbook division was sold to another large firm who was in the process of buying up educational publishing houses. That firm then merged with still another corporate giant who had also been buying up other publishing companies. The net result was that *Understanding Economics* became one of the victims of "merger mania."

Overall, I have devoted a great deal of my adult life to the battle against economic illiteracy which continues to threaten our future, both as individuals and as a nation. This major national problem is evidenced by the following

excerpt from the June 14, 1999 issue of *U.S. NEWS & WORLD REPORT*.

“On a recent nationwide test of basic economic principles, two thirds of the 1,085 high school students who took it did not even know that the stock market is where people buy and sell shares—never mind that investments can tumble. Worse, few understood that scarcity drives up prices or that money loses value in times of inflation—two consumer fundamentals. Average grade: F.”

The magazine article refers to a study conducted by Louis Harris & Associates on behalf of the National Council on Economic Education. The survey is based on interviews with a national cross-section of 1,010 adults aged 18 and over and a representative sample of 1,085 students in grades 9 through 12.

The results of the survey are shocking. On average, adults got a grade of 57 percent for their knowledge of basic economics compared to an average score of only 48 percent for high school students. Specifically, only 37 percent of adults and 36 percent of students recognized that the statement, “money holds its value well in times of inflation” is incorrect. In the area of public finance, only 54 percent of adults and 23 percent of high school students knew that when the federal government spends more in a year than it collects in revenue for that year, there is a budget deficit. Also, 22 percent of adults and 25 percent of students confuse the definition of a budget deficit with the national debt.

The National Council on Economic Education, who commissioned the national survey of economic literacy, is a nonprofit partnership of leaders in education, business and labor. The council has established a nationwide network of state councils and over 260 university-based centers to train teachers to teach economics to our nation’s young people. One week after releasing the shocking results of its national survey on economic literacy, the Council announced an am-

bitious five-year, nationwide campaign to increase economic literacy among both students and adults.

“Despite the failing grades and the revelation that only 13 states require students to take a course in economics before graduation, the research also told us that a resounding 96% of Americans want basic economics taught in our schools,” stated Robert Duvall, President and CEO of the Council. “We intend to be the catalyst to make that happen. As of today, we are mounting a concerted drive to focus national attention on the need to make economics an education priority for every American.”

Although economics has a greater impact on our daily lives than almost any other academic subject, it is not a general education requirement for a college degree. The net result is that the majority of college-educated Americans know very little about basic economics.

The American public must become better informed about economic issues to ensure that our government does not return to some of the failed economic policies of the past that could threaten our future and that of our children and grandchildren. Good economics and good politics are often in direct conflict, and when politicians have to choose between the two, they almost always choose good politics.

The purpose of this book is to make basic economics accessible to everyone regardless of educational background. It is written in simple language with the use of concrete examples that relate economics to ordinary daily life. This second edition has been expanded to cover important additional subject matter that was not in the first edition, but I have placed a high priority on maintaining the clarity of presentation that made the first edition so reader-friendly. Welcome to the world of economic literacy!

CHAPTER 1

INTRODUCTION TO ECONOMICS

Economics is the study of choice. *Specifically, economics is the study of how individuals and society choose to use limited resources in an effort to satisfy people's unlimited wants.* Both individuals and nations have limited resources. Individuals have only so much money and other assets, and only so much time. A nation has a limited number of factories and machines, working-age people, and natural resources. But, despite the existence of limited resources, people still have unlimited wants. We do not have nearly as much as we would like to have.

Together, the problems of limited resources and unlimited wants form what is known as the problem of **scarcity**, which is the most basic of all economic problems. Without the problem of scarcity, nobody would have to worry about financial problems, because there would be enough of everything to meet everyone's wants. Of course, we don't live in such a world. There are just not enough resources for people to have everything they want. No nation in the world has enough resources to provide for all the wants of its people, and few individuals in any country get everything they want. As a result of the problem of scarcity, we must all make choices. We must choose among alternatives.