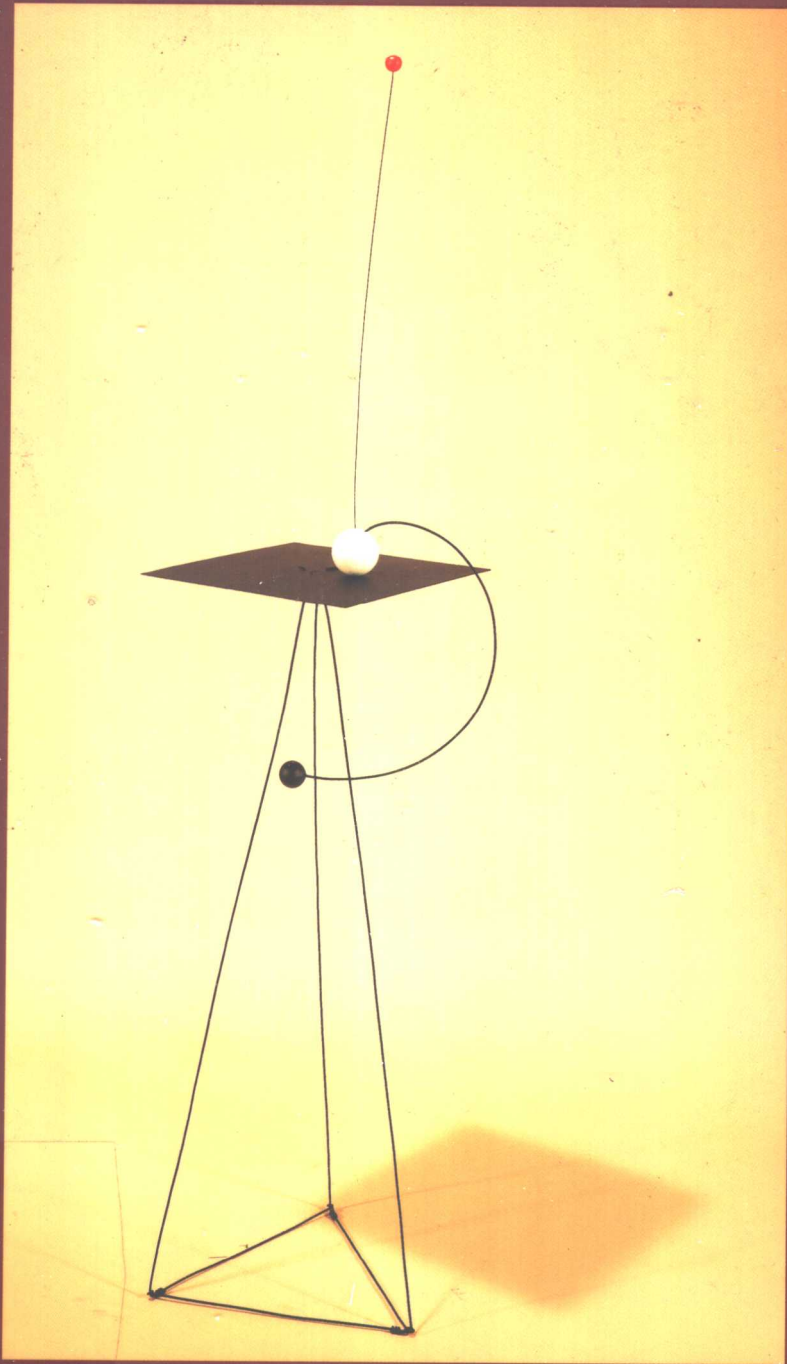


# COLANDER



# ECONOMICS

FOURTH EDITION

# ECONOMICS

David C. Colander

Middlebury College

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## ECONOMICS

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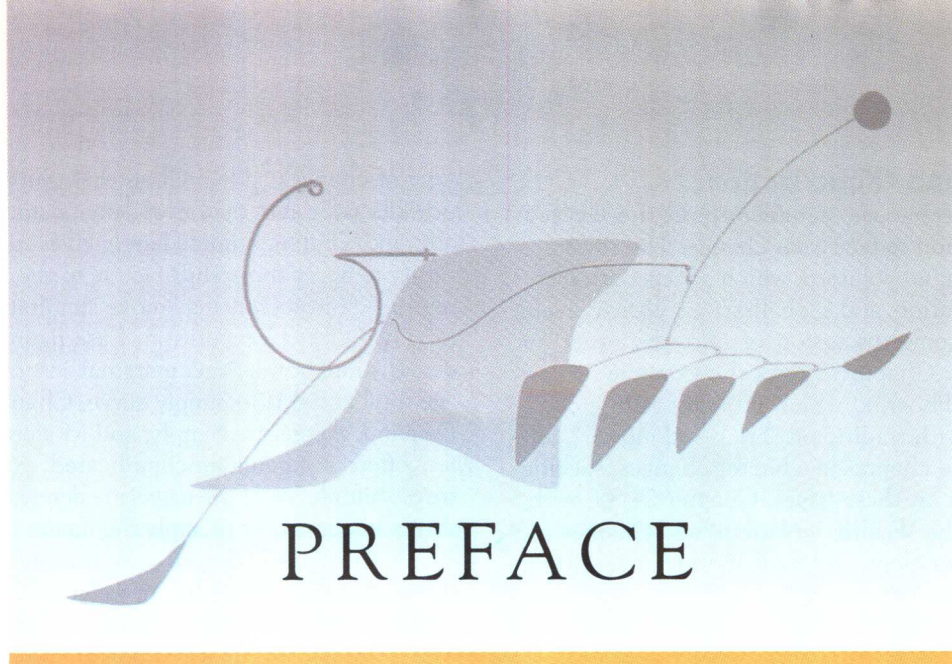
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# PREFACE

"Imagine . . . a textbook that students enjoy!" An instructor at a large school in the Midwest e-mailed me that comment just as I began to write this preface. It captures what I believe to be the most distinctive feature of my book—students actually enjoy reading it.

The first edition of *Economics* was well received; it was, in large part, a standard book in both tone and structure. Students liked it, but it was seen by some as a bit idiosyncratic; it had its own presentation of AS/AD, some novel metaphors, and had significantly more history and information about institutions than most books had.

As I have emphasized in my writing about textbooks there are strong forces pulling all textbooks toward a middle ground, and those forces have affected my book too. In the second and third editions I removed some of the idiosyncrasies while maintaining the voice that appeals to students. This edition continues that process.

## NEW TO THE FOURTH EDITION

The fourth edition is the most teachable yet. It is shorter; it reflects many recent changes in the economy and the profession; and many of its more challenging presentations have been simplified. The following sections review the major changes. Please visit the Colander Web site ([mhhe.com/economics/colander](http://mhhe.com/economics/colander)) for a complete list.

### ● Shorter

There's a fine line between inclusive and encyclopedic; previous editions tried to be inclusive but not encyclopedic. Encyclopedias don't excite students. I've felt this way for a long time, but could never decide what material to

leave out, which left previous editions bordering on the encyclopedic edge. This edition pulls away from that edge. When developing this edition my editors asked instructors which chapters they assign. The instructors told us they liked many of the later chapters but didn't have time to teach them. I decided to cut any chapter that was assigned by fewer than 15 percent of our users. The result was a text that is five chapters shorter than its predecessor. I used the same criterion to cut numerous appendixes. I also tried to cut out tangents from chapters so that students could more easily focus on core content. The result is a shorter, cleaner, more straightforward presentation of the central ideas of economics. Fourth edition. Chapter 3, The U.S. Economy in a Global Setting, which combines third edition Chapters 5 and 6, is an example of the type of changes I made. The combined chapter is much shorter, and surveys the issues while saving the analysis for the micro and macro core chapters.

The fourth edition presents micro first. I made this change for two reasons. First, it's logical; second, the reason for putting macro first has been reduced, if not eliminated. When I wrote the first edition the belief was that macro, with its emphasis on public policy, was more interesting to beginning students. However, many of the most compelling policy issues being discussed today concerning the Internet, deregulation, and the environment, are micro, not macro topics. Putting micro first allows us to get into those fascinating issues early on. It is important to point out that putting micro first does not mean that the macro presentation requires micro to be taught first. The book remains flexible and nothing in macro is dependent on students having had micro.



## ● Innovation and Globalization

The economy has changed significantly in the last few years and this edition reflects that change. The revisions emphasize the digital revolution, which affects both technology and innovation and globalization. Nearly every chapter includes some discussion of one, the other, or both. An example: Chapter 2 gives the example of how the University of Phoenix, which provides online classrooms, competes with traditional “brick and mortar” colleges. Besides these chapter-by-chapter changes, specific chapters also focus on these issues. Chapter 24, Growth, Productivity, and the Wealth of Nations, and Chapter 14, Globalization, Technology, and Real-World Competition, focus on technology and growth.

## ● Changes in Style and Pedagogy

In response to reviewer feedback, the fourth edition contains fewer nonstandard terms and presentations. For example: The first three editions used metaphors—the invisible foot, hand, and handshake—to describe the political, social, and economics forces that influence the economy. I still like those metaphors, but several instructors thought they were distracting so I eliminated them. I discuss political and social forces; I just don’t use the metaphors.

The second and third editions included the “portable tutor,” a pedagogical aid that uses the text margins to ask questions that reinforce Learning Objectives and to remind students of important material. The fourth edition continues that practice and expands it by using World Wide Web icons that direct the student to our Web site, which contains content-enriching Internet research exercises.


Terminology is meant to facilitate learning. If it becomes overwhelming, students don’t get past the nomenclature to the concepts. In this edition we identified the terms that help students focus on the core material and made sure those definitions were clear and used consistently from chapter to chapter. An example of revised terminology appears in Chapter 8, The Logic of Individual Choice: The Foundation of Supply and Demand. Based on reviewer feedback I replaced the term “utils” with “units of utility.” Not a big change, but one that keeps the terminology standard.

Another major change is, for the most part, invisible. It involves enormous work by me; my assistant in writing this book, Jenifer Gamber; my editors at McGraw-Hill; and the reviewers. We went through the book line by line to ensure that the pedagogy was solid. Earlier editions were sometimes described as a “big picture” book. The “big picture” remains, but in this fourth edition the details are clearer. This edition presents a brick-by-brick, click-by-click structure in which the presentation is clear and logical from the ground up. Here are some examples of the

type of changes added: Chapter 4, Supply and Demand, now discusses shift factors of demand and supply individually, and Chapter 5 immediately gives students the opportunity to apply those shift factors to the real world, where multiple shift factors may move simultaneously. In Chapter 11, Perfect Competition, I use figures and a graph to demonstrate how a firm’s marginal cost curve (above average total costs) is its supply curve. Chapter 25, Aggregate Demand, Aggregate Supply, and Modern Macroeconomics, offers a careful, uncomplicated explanation of the three shift factors of the aggregate demand curve, and then shows students how to apply the model to policy issues.

Learning depends on organization—both mine and the students’. In this edition, we’ve worked hard to make elements dovetail within chapters. Learning Objectives, which are consistent with the structure of each chapter, serve as quick chapter introductions and can be used by students as self-quizzes. Judiciously chosen key terms are carefully defined in context, and chapter summaries consolidate main points within the Learning Objectives framework. End-of-chapter questions, including many that require Internet research, reinforce Learning Objectives as they test student comprehension.

Pedagogy should reinforce content and help students do well on exams. This requires a clearly written book, but also a book that gives students an opportunity to try out their new knowledge. In addition to the critical thought questions that have been a hallmark of previous editions, the fourth edition includes more fundamental questions so students can be sure they know the basics.

Web Note icons  in the text margins indicate brand new exercises related to book material. The exercises themselves are on the Website: [www.mhhe.com/economics/colander4](http://www.mhhe.com/economics/colander4). Each chapter also ends with a set of Web questions that direct students to a variety of sites from think tanks to government data sites to business-related sites. These new questions fill many roles: They help students see how the concepts in the chapter really do relate to real-world issues; they familiarize students with the mass of information on the Internet; and they give students the chance to apply the concepts they’re learning.

In another pedagogical change we’ve reorganized the boxed material to fit the theme of “tools, not rules.” The boxes in this edition are of three types—Knowing the Tools, Applying the Tools, and Beyond the Tools. Each of the core theory chapters contains a Knowing the Tools box that reviews that chapter’s most important concepts, models, and definitions. Applying the Tools boxes provide real-world applications or information related to the chapter. Material that places a concept in a broader or more institutional context appears in Beyond the Tools boxes.

These carefully defined boxes help students categorize complementary content as they read through the chapters.

We've also kept the popular colloquial glossary that has been a favorite of ESL students.

### ● Major Changes in Micro

The most significant changes in micro involve a reorganization of the structure—putting more policy earlier, and combining policy discussions, which brings students to interesting policy issues much earlier than before. For example:

- *Early policy application.* New Chapter 7, Taxation and Government Intervention, which takes up some of the issues of government intervention first introduced in Chapter 5, gives students the opportunity to apply the concept of consumer and producer surplus learned in Chapter 4, and elasticity learned in Chapter 6. It includes taxation, price floors and ceilings, and quantity restrictions. Efficiency is discussed in relation to all of these issues. Politics and rent seeking are introduced as a fight over who gets what portion of total surplus.
- *Increased coverage of technology and globalization.* New Chapter 14, Globalization, Technology, and Real-World Competition, brings together issues that were dispersed among several third edition chapters. The first half of the chapter continues to discuss how goals of real-world firms are different than assumed by the models and examines the fight between competitive and monopolistic forces. The second half discusses how globalization and technological advances have affected real-world competition. I note how firms have become more specialized, which makes the potential for gain much larger than it used to be. I also examine the ways in which technological advances both affect competition and are affected by it.
- *Revised policy coverage.* New Chapter 15, Government Policy and Market Failures, simplifies the teaching of policy by consolidating the policy discussions that appeared in third edition Chapters 31 and 32. It gives an easily remembered policy framework for students: Anytime there is a market failure, there is a reason for possible government intervention. This chapter considers three sources of market failures (1) externalities, (2) public goods, and (3) incomplete information. Each market failure is introduced and its failure is considered using perfect competition as a benchmark. Alternative methods of dealing with each market

failure are also discussed. The chapter ends by questioning whether government can address market failures successfully or whether government intervention makes the situation worse.

- *Revised policy coverage.* The mostly new Chapter 17, Microeconomic Policy, Economic Reasoning, and Beyond, borrows from third edition Chapter 30. Its two parts put economic reasoning into practice. The first part extends the supply/demand model to a broader cost/benefit framework. The second part considers both the costs and benefits of using economic reasoning. It notes that markets that are working perfectly (no market failures) might still lead to undesirable outcomes. Three failures of market outcomes are considered: (1) failures due to distributional issues, (2) failures due to human irrationality, and (3) failures due to violations of inalienable rights. The chapter also emphasizes that such failures are not necessarily calls for activist policy; policymakers must recognize that government failure exists. Policy is generally a debate about which failure is worse.

### ● Major Changes in Macro

The three biggest changes in macro are (1) a restructuring of the macro presentation to a long-run first presentation, (2) the change to a more traditional treatment of the AS/AD model, and (3) the focus on a single model with fewer Keynesian/Classical distinctions.

- *Expanded and earlier coverage of growth.* New Chapter 24, Growth, Productivity, and the Wealth of Nations, presents the long-run framework that determines potential income and growth before presenting the short-run framework relevant for fluctuations. This change reflects the growing interest in the long run, and sets the stage for an integrated discussion of macro policy. The growth presentation is an intuitive one, emphasizing gains from trade, specialization, and division of labor, not an analytic one based on the Solow growth model. The chapter presents the empirical evidence showing a correlation between markets and growth, and discusses why markets lead to growth. It concludes with a discussion of government policies that promote growth.
- *Surrender to AS/AD Terminology.* Those of you familiar with my book and with me know that I have battled against the way AS/AD is presented in the text. In this edition I surrender. My alternative terminology did not catch on at the principles level; it involved simply too much analytics for students

to learn, and so in this edition I use standard AS/AD terminology. I don't regard the fight as a total loss. In some ways I, together with a large number of other economists who wrote technical articles, won the battle; all principles books now do a much better job of presenting the AS/AD model, and distinguishing it from a micro supply/demand model, so using it is not so objectionable.

- *The AS/AD modification required major changes.* In Chapter 25, Aggregate Demand, Aggregate Supply, and Modern Macroeconomics, I first simplified the presentation of both the AS and AD curves. The AD curve is presented clearly with a minimum of technical additions. Similarly, to keep the presentation as simple as possible, and consistent with recent experience, the short-run AS curve is presented as perfectly elastic, with changes in price levels coming from changes in factor prices in excess of rising productivity. Combined, these two curves create a simple model that can be easily applied to discuss policy issues. Moreover, because I developed potential income in the previous chapter I now use the AS/AD model to bring together the short-run and long-run frameworks.
- *Fewer Keynesian/Classical distinctions.* Modern economics has arrived at a combined macro model that most economists support; this edition focuses on that model and downplays the Keynesian/Classical policy debates that were central in earlier editions. There are still differences of opinion, but they are differences of interpretations within a model, not differences of models.
- *Repositioned money and banking chapter.* Chapter 29, Money, Banking and the Financial Sector, now forms part of a more standard sequence. It comes after the discussion of theory and immediately before the monetary policy chapter.
- *A change in focus from deficits to surpluses.* The revised, briefer Chapter 28, Politics, Deficits, Surpluses, and Debt, reflects current reality by shifting emphasis from deficits to surpluses. In order to facilitate an early discussion of the integration of long-run and short-run budgetary issues, it comes just after the fiscal policy chapter. Two timely and relevant case studies—current and projected budget surpluses and Social Security reform—are presented.
- *A simplified presentation of inflation.* Chapter 31, Inflation and Its Relationship to Unemployment and Growth, has been simplified considerably. The first half of the chapter replaces the previous Keynesian/Classical inflation arguments with a simpler presentation of the basics of inflation. The chapter is given a contemporary policy focus with examples from Chile, Finland, Brazil, and New Zealand. The connection between the short-run and long-run Phillips curve has also been simplified.
- *A switch in the order of international chapters.* Chapter 32, Open Economy Macro: Exchange Rate and Trade Policy, now appears before the other international macro chapter (International Dimensions of Monetary and Fiscal Policies). It includes timely coverage of the late 1990s currency crisis, recent developments in Asia, and the evolution of the euro.
- *A new summary chapter.* New Chapter 34, Tools Rules and Policy, capitalizes on the fourth edition's thoroughly integrated theory and policy discussions and helps students prepare for the final exam by tying together tools, institutions, and policy discussions. It first reviews the models and then uses them to explain and discuss policy. It emphasizes policy regimes and contemporary policy expectations, including the need for credibility. The chapter ends by addressing the question, "Has the economy entered a new era?"

## ● Standard Updating

Every chapter has been updated with the latest possible statistics and the most up-to-date policy discussions.

## ● Design

Besides being different; the fourth edition also *looks* different. The design is more open and the typeface more reader-friendly. A lighter color palette makes the graphs and charts easier to read. The Tools boxes are more integrated so students are less likely to skip over them. Visual elements based on the works of sculptor Alexander Calder provide a subtle, whimsical reminder that the economy, like mobiles, involves intertwined parts that need to be carefully balanced and coordinated.

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## WHAT WE'VE KEPT

The above discussion may make this seem like a whole new book; it isn't. *Economics* is still written by me with the same essential elements that differentiate it from other books. This includes the focus on teaching economic sensibility and the maintenance of my voice, both in the examples and in the passionate writing style. It also includes an approach that my friend, David Littlehale, describes as aggressively neutral. He points out that I have this trait of

going right into the middle of fights, rather than shying away from them, and picking on both sides. I end up neutral, but not in the standard way.

Finally, while institutions and history receive less coverage, they are still important to me, so you will still find more historical and institutional issues in this book than in almost any other principles book.

## ANCILLARIES

All reviewers agreed that the third edition ancillaries were top rate. If there was a problem it was that there were too many of them. Thus, in this edition we have consolidated and incorporated the best of the previous edition's supplements into an accessible, convenient package.

### ● Study Guide

We combined the best of the *Drill and Review Study Guide* and the *Student Workbook* into a single *Study Guide*. This guide, written by myself, Douglas Copeland of Johnson County Community College, and Jenifer Gamber, reviews the main concepts from each chapter and applies those concepts in a variety of ways: short-answer questions, matching terms with definitions, problems and applications, a brainteaser, multiple-choice questions, and potential essay questions. Since students learn best not by just knowing the right answer but by understanding how to get there, each answer comes with an explanation. Timed cumulative pretests help students prepare for exams.

### ● Instructor's Manual

In the fourth edition, Tom Adams of Sacramento City College has raised the standard for all *Instructor's Manuals*. Eight new features make class preparation easier than ever. "Chapter Overview" and "What's New" provide a quick review of each chapter. "What's New" will be invaluable when modifying lecture notes to fit the new edition. The manual provides comprehensive lecture outlines, but it also offers help for inevitable classroom trouble spots. "Discussion Starters" will help engage students and keep them thinking. "Tips for Teaching Large Sections," written by Gail Hoyt of the University of Kentucky, offers innovative ideas for teaching very large classes. "Student Stumbling Blocks" provides additional explanations or examples that help clarify difficult concepts. "Ties to the Tools" helps bring those text boxes into the classroom; a comprehensive list of relevant URLs brings the Internet in too. Every chapter's 10-question "Pop Quiz" will help students prepare for exams. The "Case Studies" provide contemporary, real-world economic examples. The entire instructor's manual is available in print and electronic forms and on the Colander Web site.

### ● Test Banks

James DeVault of Lafayette College and Susan Dadres of Southern Methodist University revised Testbanks A and B (the 10,500 question multiple-choice test banks). Each question is categorized by chapter learning objective; level of difficulty (easy, medium, hard); skill being tested (recall, comprehension, application); and type of question (word problem, calculation, graph). Approximately 30 percent of the questions are new and many more are revised. Each question was reviewed by Jenifer or myself for accuracy, clarity, and consistency with the textbook. They are available in print form, in the Diploma electronic test generating system, and on our Web site.

Expanded Test Bank C, written by Patrick O'Neill of the University of North Dakota, now consists of approximately 600 short-answer questions, essay questions, and graphical and mathematical problems. Questions vary in level of difficulty and type of skill being tested. They are available in print and electronic form, and on the Web.

### ● DiscoverEcon

This menu-driven software, which was developed by Gerald Nelson at the University of Illinois, is a complete text-specific student tutorial. Each chapter includes essay questions, Web links and research questions, and a multiple-choice quiz. Interactive graphing problems, animated charts, and live tables help students understand how different data impact the economy. Text references and glossary links help clarify key concepts. Exercises are graded immediately, and results can be submitted to the instructor either on paper or electronically. It is available as a CD version and in an online version. (The online version is accessible only to those who buy the Discover Econ Online text package.)

### ● PowerPoint Presentation

Anthony Zambelli of Cuyameca College has once again prepared an extensive slide program that includes all text exhibits and key concepts. They are available on a CD-ROM and on our Web site.

### ● Overhead Transparencies

We offer all key text exhibits in full-color acetate form for use with overhead projectors.

### ● Economics Web Newsletter

This electronic newsletter contains ten questions related to current economic events that can be used as an in-class quiz and reprints one recent *Wall Street Journal* article along with five in-depth questions (and answers) that are tied to specific text chapters. Seven new exercises will be added each semester.



## ● Classic Readings in Economics

This collection includes selections from the writings of economists, such as Smith, Marx, Hayek, or Veblen, who have raised questions that changed the direction of economic thinking. This material is especially useful for courses that stress the importance of economic ideas.

## ● Economics: An Honors Companion

The *Honors Companion* presents mathematical techniques that underlie numerous basic economic concepts. It presupposes a solid student background in algebra and geometry and some familiarity with basic calculus, thereby giving *Economics, Fourth Edition*, flexibility for use in more rigorous classes.

## ● On the Web

Our new Web site offers a wealth of materials for both students and teachers. The eLearningSessions, prepared by Douglas Copeland of Johnson County Community College, are a set of Internet modules based upon a mastery system of learning, reviewing, and testing. Students are initially presented with an introduction to each chapter and then asked to take a pretest, which is then graded and returned with correct answers and rationales. Students can then address any weaknesses in their understanding by using one of several study modules: Key Terms, a list of the key terms of the chapter with a link to their definitions; Learning Objectives, what students should take away from the chapter; a Tutorial, three to five exercises, with a step-by-step guide answering each question successfully; and some Practice Exercises, three to five additional problems and answers. The session is completed when students take a multiple-choice posttest.

Students can also broaden their understanding with Web Notes and Current Events, two features prepared by Kit Sims Taylor of Bellevue Community College. Web Notes—Web exercises written for the textbook and identified in the text by margin icons—present links, articles, short analysis, and follow-up questions focusing on each chapter's key points. Current Events—a set of six current, real-world issues with introductions, links to articles and follow-up questions—will be updated throughout the year as issues facing our economy change. In addition, the student center includes a listing of each chapter's Web Questions, a Bulletin Board, Frequently Asked Questions, Bonus Chapters, a guide to writing economics, a career center, a graphing tool, and the Economics Web Newsletter.

Teachers will also find, among other things, the Instructor's Manual, solutions to end-of-chapter questions, PowerPoints, Sample Syllabi, a bulletin board for instructors and a link to my own Web site.

I'm very proud of the ancillary package. I think you will find that its high quality, its enormous diversity, and exceptional utility make the book a complete learning system.

## PEOPLE TO THANK

A book this size is not the work of a single person, despite the fact that only one is listed as author. So many people have contributed so much to this book that it is hard to know where to begin thanking them. But I must begin somewhere, so let me begin by thanking the fourth edition reviewers, whose insightful comments kept me on track.

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### First Edition

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