

INVITATION TO ECONOMICS



A FRIENDLY
GUIDE THROUGH
THE THICKETS OF
"THE DISMAL SCIENCE"

JIM EGGERT

JOHNSON

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**A Friendly Guide
Through the Thickets of
"The Dismal Science"**

Jim Eggert

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Cartoons by Robert Cavey.
Photographs by Jim Eggert

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PREFACE

The purpose of *Invitation to Economics* is to combine into a single volume the essentials of macroeconomics and microeconomics. Much of the material was, in fact, drawn from my two narratives, *What is Economics?* and *Investigating Microeconomics*. Yet there is more here than just the marriage of two books. Of interest to those who teach Principles of Economics are new chapters on international trade—reflecting the greater role that the world economy plays in each and every nation, including our own. Note too, the microeconomics section containing a greatly simplified indifference curve and equal product curve analysis designed specifically for the beginning student. Also, I ought to mention one especially friendly guide. His name is Chester Olsen. We'll be watching Chester illustrate a number of important economic principles and ideas as he weaves in and out of the text.

As you read these pages, I hope to *encourage your curiosity* about economics. Indeed, my objective will have been achieved if this book urges the reader to dig deeper into principles and issues—to the point where he or she may feel confident to actively participate in the great economic debates of the day.

A warm thanks to my wife Pat and to my father Bob Eggert; and also to Dave Liu, Lou Tokle, Sunny Olds, Martin Giesbrecht, and the many other readers who, without doubt, made this a better book. And too, a very special thanks to James Pinto. Jim not only made helpful suggestions, but he also single-handedly prepared the supplementary Student Study Guide.

Finally, I wish to thank Dayle Mandelson (for the title suggestion), cartoonist Bob Cavey (whose cartoons always add a measure of fun and delight!), and, of course, all my "econ" students whose indirect contributions would be difficult to measure.

Jim Eggert
University of Wisconsin-Stout
Menomonie, Wisconsin

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Part I

THE U.S. ECONOMY



Chapter 1

What Is Economics?

What Is Economics?

Unfortunately, there is no single or simple answer to that question. Originally, economics meant home management: economics was thus the study of how to organize and manage the resources of the home. What are these resources? They include things like money, time, working and living space, and so forth. What do all the items on our resource list have in common?

First, for any given household, the resources are limited. Very few people, for example, can honestly say that they "have enough." How often have you heard people say, "I wish I had more time," "I wish I had more money," or "I wish I had more space"? Limited resources are therefore a universal frustration. Second, these resources can be organized in many different ways; i.e., we can *choose* how these resources are used.

Families do have other resources, however, that aren't as easily manipulated, for example, love, family unity, good memories. These are also important in determining a person's welfare, but they, and other values as well (ethical, aesthetic, and religious values), are outside the realm of economics; you can't honestly put a monetary value on them, nor can you manipulate them to meet desired objectives as you can with your time or your money.

Thus, our definition of economics includes the idea of choice, that is, how a family (or company or nation) may choose to use its limited resources to best meet its economic objectives. These objectives can range from bare survival to high material comfort, depending on the available resources and how well or how poorly these resources are organized. This is what economics is all about.

Let us now extend our view from the household economy to the national economy. The basic economic problem is the same: the nation's resources are limited. Our material demands, however, tend to be unlimited, and the nation must learn how to best organize its resources to satisfy its material wants. Unwise use of resources—whether by consumers, businesses, or governments—can bring about unfortunate results such as unemployment, inflation, poverty, and (in extreme cases) hunger or starvation. The study of economics can help us understand how we might avoid such mismanagement of national resources.

National Resources

What exactly are our national economic resources? The first and primary resource is *labor*. This includes the millions of men and women in the U.S. labor force: the doctor, the farmer, the butcher, the assembly line worker, and so forth.

Next is *land*. America's land resources include every natural resource above, on, and below the soil. Air is a land resource, as is crop land. The mineral ores and petroleum in the crust of the earth are also land resources. These resources are distinguished by the fact that man cannot make more of them. The earth has only so much topsoil and so much oil. Once the topsoil has been destroyed¹ and the oil burned up, they will be gone forever.

The third major resource is *capital*. Many people think that capital means money; you often hear someone say "I need to raise so much capital for my new project." What is actually being referred to is financial capital. To the economist, capital means the physical tools that aid the worker in production. In other words, capital goods are man-made, can be reproduced or replaced, and tend to increase the productivity of labor. What are some examples of capital goods? The typewriter that I use is a capital good. It is a tool that increases my output; it's man-made (unlike land resources); and, once it wears out, I can replace it. The pen that you wrote your last check with is a capital good and so is the car that gets you to work. In fact, all machinery, tools, buildings, plants, and equipment are capital resources. (You can see now that there is much more to the meaning of capital than just plain money.) Capital goods are thus very important in determining the nation's level of wealth and economic growth.

Finally, we come to that elusive resource called *management*. The manager is quite special in our economy; it is he or she who coordinates and organizes all the other resources in order to produce and market the products and services that people want, thereby creating a profit. In the old days, the manager was called an entrepreneur; we think, for example, of Henry Ford or Andrew Carnegie as large-scale managers personifying this scarce resource. Perhaps the days of the great "wheeling-dealing" entrepreneurs are over, but whether you are talking about the bakery down the street or General Motors, some one person or group of people must still coordinate resources to produce saleable products and services.

Asking Questions, Making Choices

Thus, labor, land, capital, and management are the four major resources available to our economy to produce goods and services that people need and want.

To define a working economic system, however, we must ask further questions; for example, *How does an economic system determine what will be produced?* What will our economic output consist of, and who will determine its composition? Will our economy produce bombs and tanks or hospitals and homes? Small cars, large cars, or bikes and trains? Gas, oil, or solar heat? Who or what will decide for us? Of course, different economic systems will provide different answers to these questions. The Soviet Union or communist China determines what will be produced in a manner somewhat different from that of the United States or Brazil.

In addition, there are other important questions to ask, such as, *How does the economic system decide who gets the output?* Why are incomes, goods, and services distributed the way they are? Throughout U.S. history, dividing up the economic pie has always been a very controversial question. Will our economic system give a majority of the output to a few "super rich" families, will it try to divide the pie up more equally, or will it fall somewhere in between? Uneven distribution of incomes and wealth is often a result of differences in education, intelligence, skills, work habits, monopoly power, geography, family background, luck, and political or social savvy. More equal incomes, on the other hand, usually come about through government policies such as minimum-wage

laws, progressive taxation, subsidized education, and welfare assistance.

And finally, there is the question, *How will these goods be produced?* At first glance, the answer might seem to be a purely technical one. Building an automobile, for example, is a problem for the engineer. And yet we know there are really many ways to produce a finished automobile. Ideally we want to build efficiently, using abundant, low-cost resources in place of scarce, high-cost resources. Assembling that car one way in preference to another returns us to the question of allocating resources. Choosing the correct techniques for production (conserving the scarce resources and using the abundant) is thus as much an economic problem as it is a technical or engineering problem. Economics is therefore the science (or art) of making choices—choosing the best way to organize our limited resources in order to meet our material needs.

Finding Answers

The method by which an economic system answers these questions varies from time to time and from country to country. Economist Robert Heilbroner in his excellent book, *The Making of Economic Society*, explains that there are in fact three basic systems for organizing economic resources.

The first is called *tradition*. The decision makers in a traditional system answer these questions by saying, "We will organize our economy the way we have always organized it." Tools and houses are constructed as they were always constructed. Junior goes into the same trade as his father. Output is allocated by custom, with few changes over the years and only with minute trial-and-error improvements over the centuries.

Economics by tradition certainly has some advantages: There is very little conflict, and there are few expectations that can't be met. But it is likely to be a stagnant system offering relatively low levels of economic well-being for its people. If you feel that having more choices moves you closer to the good life, then the traditional economic system is probably not for you.

Yet we certainly have elements of tradition in our so-called modern economy. For example, my own father is an economist, and he was once a teacher. Many instructors still use a lecture

method that dates back to Plato in ancient Greece, even though some critics think that the lecture technique should have been dropped with the invention of the printing press. Whether the critics are correct or not, contemporary education certainly adheres to very traditional methods of performance. Women, too, have become more aware of the extent to which their lives are determined by social and economic tradition.² By discriminating on the basis of sex and thus eliminating a large proportion of our population from competing for highly productive and professional jobs, our economy has lost a potentially vast economic force. You can probably think of many more examples of how tradition subtly weaves in and out of our supposedly "modern" economy.

The second way to solve the economic problem is with a *command system*. A command system is characterized by the allocation of resources, incomes, prices, etc., by a centralized authority; in other words, a dictatorship. The command system invites no questions—either you follow orders or you take the consequences. This system is often the offspring of a despotic political system; they frequently go hand in hand. The economy of the Soviet Union is a good example.

European democratic socialists believe, however, that we can have a planned, state-directed economy without the terror. The combination appears to be difficult, and yet democratic state planning has been approximated in Scandinavia, Japan, and a few eastern European countries. The U.S. economy too has some elements of economic command. Our military services, for example, work on this principle, as does the government allocation of goods during wartime. When price-wage controls are in effect, we have a perfect example of government command. Furthermore, almost all government laws on economic affairs (including our tax system) constitute direction from above. By and large, however, our private enterprise system cannot really be called either command or traditional.

What we have in the United States is a *market economy*. The market system is a relatively recent phenomenon. Instead of using force to get things done (as in the command system), the market system motivates people by offering economic rewards within a process of exchange. Instead of government direction, decisions on resource use are made by millions of independent individuals and

institutions attempting to do what is best for themselves or their businesses. Here the economic mule moves by carrot instead of stick. The U.S. economy is indeed a system of carrots.

If the command system is centralized, the market system is decentralized. A market economy churns out prices in countless markets of supply and demand, and these prices in turn act as guidelines in a new round of economic decisions; it is a competitive, interdependent, and self-regulating system. If you and I were not so accustomed to such an arrangement, we might find it somewhat strange, as we see in Heilbroner's little scenario:

... assume for a moment that we could act as economic advisors to a society which had not yet decided on its mode of economic organization. Suppose, for instance, that we were called on to act as consultants to one of the new nations emerging from the continent of Africa.

We could imagine the leaders of such a nation saying, "We have always experienced a highly tradition-bound way of life. Our men hunt and cultivate the fields and perform their tasks as they are brought up to do by the force of example and the instruction of their elders. We know, too, something of what can be done by economic command. We are prepared, if necessary to sign an edict making it compulsory for many of our men to work on community projects for our national development. Tell us, is there any other way we can organize our society so that it will function successfully—or better yet, more successfully?"

Suppose we answered, "yes, there is another way. Organize your society along the lines of a market economy."

"Very well," say the leaders. "What do we then tell the people to do? How do we assign them to their various tasks?"

"That's the very point," we answer. "In a market economy no one is assigned to any task. The very idea of market society is that each person is allowed to decide for himself what to do."

There is consternation among the leaders. "You mean there is no assignment of some men to mining and others to cattle raising? ... What happens if no one volunteers to go into the mines, or if no one offers himself as a railway engineer?"³

The leaders argue on and on, unable to fully comprehend what motivates people in a market system—despite the explanation that it is in everyone's self-interest (more money, profits, etc.) to do whatever is necessary. Finally, the African representatives end the discussion saying, "We thought you had in mind a serious proposal.

But what you suggest is madness," and then with great dignity they take their leave.

Economic Sacrifices

Another way of looking at economics is to examine sacrifices. Economists call these *opportunity costs*. What exactly do they mean?

Let's say that you have spent half an hour reading this chapter. By spending this time reading, you have given up doing something else. In all likelihood you have given up a number of activities you would have enjoyed. Thus, when you use up one of your resources (an hour of time, a dollar, etc.) the cost to you is really the opportunities that you have forfeited. That hour is gone forever and so are the alternative activities you might have enjoyed. Sometimes we hear the question, "If you had your life to live over, would you do it any differently?" If you answer yes, then you are referring indirectly to your opportunity cost.

Although the above explanation of opportunity cost is somewhat philosophical, the economic concept is much the same. Economists look at the sacrifices that must be made when the economic resources of land, labor, capital, and management are used. If, for example, we commit our resources to producing 10 million automobiles, then these resources cannot be used for alternative goods and services such as housing or mass transit. Thus, the economist (unlike the business person) is not only interested in monetary costs but also in the question of what is going to be sacrificed when resources are put to use.

The idea of looking at economic costs as sacrifices can be seen quite dramatically in Figure 1-1.

Look, for example, at point A. We can assume that A represents an economy much like our own, i.e., it has directed most of its total resources toward the production of "butter" (private consumer goods) and comparatively fewer resources toward "guns" (military expenditures). As you move away from zero on either the "guns" or "butter" line, you are producing more and more of that good. Thus, point B represents a country that has chosen to produce more military goods than consumer goods (such as the United States during World War II). Given the fact that a country has only so many total resources, they are forced to choose some mix on the

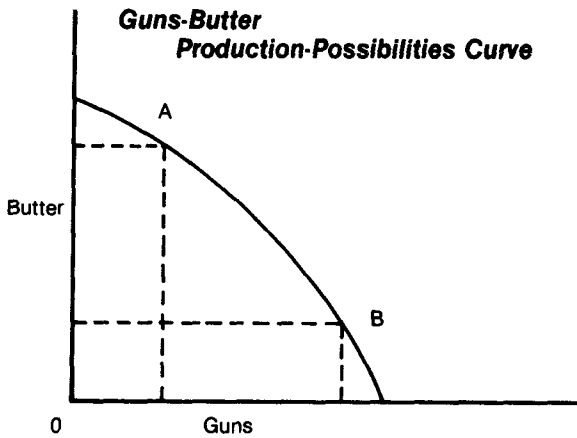


Figure 1-1

line between guns and butter. This line or curve is called the *production-possibilities curve*.

Our production-possibilities curve thus represents all the various choices open to society regarding consumer or military production. With our limited resources we may favor butter (A) or guns (B), but note that we cannot have a large amount of both goods—there are simply not enough total resources! In fact, to move from point A to point B means that the production of guns *must be sacrificed* to get more butter. Putting the opportunity cost idea slightly different, economists sometimes say, “There is no such thing as a free lunch!”

The true cost (opportunity cost) is, therefore, the measure of what is sacrificed. Thus we might view the true economic cost of a war as all the good things that could have been produced or accomplished instead. Or, the true cost of having so many cars is that the resources are not available to produce mass transit systems (see Figure 1-3).

Let’s now take a look at another production-possibilities curve, this time representing a less developed country like China.

Curve A represents China at an early stage of development, with more agricultural potential than industrial potential. How-

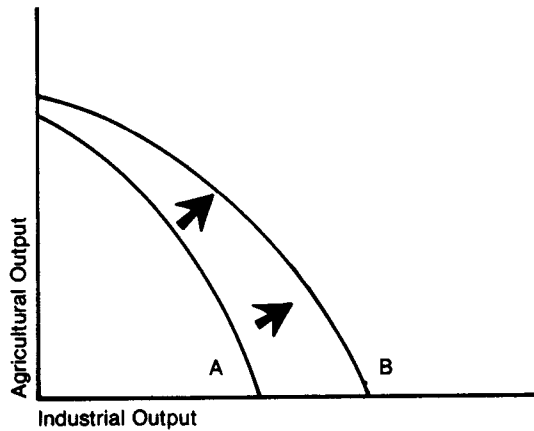


Figure 1-2

ever, an expanding production curve such as line B represents China after economic growth. The kind of economic growth that China chose in this example tended to favor industrial output over agricultural output. This is a typical pattern for economic development throughout the world.

Finally, there is an additional piece of information we can gather by examining a production-possibilities curve. Take a look at Figure 1-3.

Assume for a moment that the United States is producing a lot of cars and few mass transit systems; the country is therefore operating at point A. Suppose, though, that we decide to put more resources into mass transit and move down the curve a little way from A to A⁺. Note how much additional mass transit there is in relation to the relatively small amount of sacrificed cars. If, however, we are producing a lot in mass transit (point B) and want even more, we gain the same amount as before when we move to B⁺. Note the difference in the real cost of obtaining that extra mass transit; the number of sacrificed automobiles is much larger. We might say, then, that as we move to higher levels of mass transit, the opportunity cost of squeezing out yet *more* mass transit becomes greater and greater as more and more cars have to be sac-

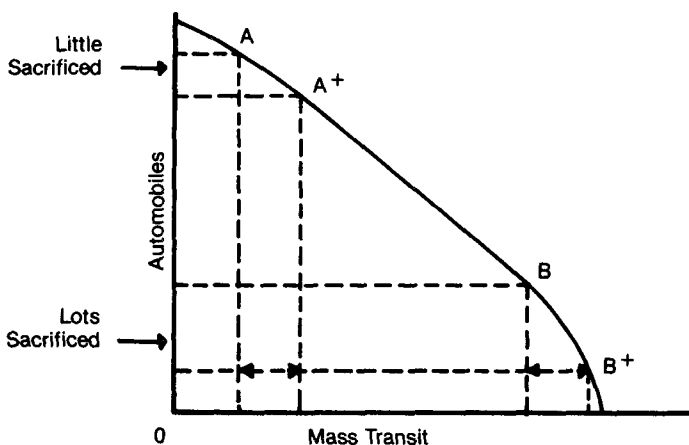


Figure 1-3

rified. Obviously when a country is producing almost all mass transit, there are few interchangeable resources left to make the switch to even more mass transit; the sacrifice (or cost), therefore, must be very high to gain these additional trains, buses, etc. Economists call this phenomenon *the law of increasing costs*.

The Economist's Concerns

Let's return to our original question: What is economics? We might answer this question by simply saying that economics is "what economists study." Most economists, in fact, are not much concerned with broad generalizations such as "studying how to best allocate resources to meet our unlimited wants." They are more interested in the specific economic problems of society, such as unemployment, inflation, balance of payments, economic stagnation, and pollution. We could then say that economics is the study of how we solve economic problems.

Alternatively, we could view economics as the study of goals, i.e., how we move closer to specific economic objectives. These economic goals are more or less universal; i.e., most countries—capitalistic, socialistic, and communistic—are striving to achieve them.