

11th Edition

ECONOMICS

ANALYSIS, DECISION MAKING, AND POLICY

George Leland Bach with

Robert Flanagan · James Howell · Ferdinand Levy · Anthony Lima

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George Leland Bach

Stanford University

with **Robert Flanagan** *Stanford University*

James Howell *Stanford University*

Ferdinand Levy *Georgia Institute of Technology*

Anthony Lima *California State University at Hayward*

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Preface

This is a book for today's serious students—for young men and women who want a good working acquaintance with the major institutions of our modern economy and an understanding of the way our economy works in dealing with both public and private problems.

Alfred Marshall, perhaps the world's most influential economist of a century ago, put the matter succinctly: Economics is a way of thinking about problems, not a set of answers to be supplied as problems arise.

This is very much the spirit of this book. We want you to be able to confront the unpredictable problems of tomorrow, using a small but fundamental analytical tool kit of economic concepts and principles, and some skills in applying them.

Modern economics uses some rigorous, abstract theory in helping readers understand complex economic situations. But we have tried to hold the abstract theory to a reasonable minimum and to keep it in "real world" settings. We try to present modern economics via real-world, down-to-earth cases and problems that will intrigue you. These cases bear directly on problems that you will care about and will be working with on the job and off.

NEW AREAS IN ECONOMICS

Interests of both students and teachers vary widely over time and the various fields of

economics. Some of the ones to which we have given special attention are:

1. Macroeconomics Our modern macroeconomics deals primarily with problems of why we have so much unemployment and so much inflation; why some nations grow so much faster and more efficiently than others, leaving great gaps of inequality both within nations and across the world. Macroeconomic analysis has seen radical innovations since the 1920s. It offers the foundation for better understanding the economic problems we face as nations. The eleventh edition of *Economics* places major emphasis on this set of developments.

2. Political Economics Market versus political processes in social choice making. It is becoming increasingly clear that society must face up to problems of social choice that affect millions of people, either by using the marketplace (economics) or the political process (democracy), or some other means of allocating voting power and choice on major issues. This 11th edition of *Economics* goes further than most elementary economics books in comparing and contrasting the alternatives, in raising the questions that are faced, and in deciding which is the better alternative to choose. The "new political economics" applies the integral tools of economics to political choices.

3. The Modern Corporation Decision making in the firm. Traditionally, economists have

not paid much attention to the inner workings of the firm—especially of the modern multinational corporation. This edition moves up to prominence the decision-making process within the firm and its implications for the way our mainly market economy will work. These issues raise the question of how effectively the market system and the profit motive do their jobs.

4. International Economics A synthesis of Keynesian income flows and classical portfolio balancing is occurring in international monetary theory as in domestic income-employment theory, which yields quite different policy prescriptions from those of last decade's theories. It is far from clear whether many nations will be able to pay their international debts. If they don't, will the system collapse? What are the likely consequences for the economy of the United States moving rapidly from net creditor to net debtor positions. We now owe other countries more than they owe us.

5. Money and Financial Markets The new edition carries an extended treatment of money, financial institutions, and monetary policy in both macro and micro sectors. This central role of money has been one of the big developments over the past quarter-century. It gets a lot of attention in the 11th edition of *Economics*.

6. Income Distribution and Labor Economics This text has an especially thorough analysis of the income distribution problem in modern primarily-market economies like the United States. *Economics* also has, for those who want it, a thorough foundation for analysis of labor markets, which are a primary source of the incomes that people receive in today's market economy. Inequality of income has long been a critical factor in how well economies work and in the development of a kind of sociological analysis.

7. Economic Growth As a foundation for our economic power and the basic foundation for our rising standard of living, economic growth plays a leading role throughout the book. We believe these interconnections are of central importance.

FOCUS ON OBJECTIVES

In writing this textbook we have used some simple, common-sense principles of learning as the basis of our teaching approach:

Motivation If students find learning interesting, valuable, and rewarding they are far more likely to learn effectively. We have used cases plentifully, some forty in all, because most students find them more interesting ways of learning how to apply concepts and theory than just reading how to do it. Cases, properly used, are a powerful way of learning by doing. These emphasize how to use the economics you are learning.

Clear Focus on Objectives If the students and the teacher aren't clear where they are trying to go and how they hope to get there, it is unlikely that they will end up where they want to be. Look at the *Preview* at the beginning of each chapter for a broad statement of the objectives of the chapter; learn to use the color of coded printing throughout the book in keeping the big points uppermost; remember that your main goal is to learn how to think effectively about economic issues, not to memorize a set of answers.

Feedback The evidence is strong that more learning occurs faster and lasts longer if the learner gets prompt and enlightening feedback on how he is doing. Thus, each chapter in the text has a set of "feedback" mechanisms that make it easy for the student to take advantage of this knowledge about learning. Organized sections of summaries and reviews, questions for out-of-class discussion, and helpful suggestions on how you can learn most from the cases in the text can also help. (See suggestions at the end of the book.)

Retention of Learning Learning is most likely to be retained if it is relevant to the learner and his interests, and is reinforced through repeated use.

Learning Through Doing Most students learn best through doing. This is true in intellectual as well as physical learning. Thus, we have provided throughout the text cases, situa-

tions, and problems where the student is given generally real, often unstructured, cases in which he or she must decide what to do and must defend the choice. We believe that in making these decisions on your own, you will learn better how to become an efficient problem-solver.

Economics can be fun and we hope to make it so, especially if you get satisfaction from understanding what makes things tick and what we can do to make things work better.

The new edition again offers a package of up-to-the minute teaching aids for both students and teachers.

Instructor's Manual Each chapter in the Instructor's Manual includes an outline, chapter summary, teaching suggestions, and answers to chapter questions from the text. Written by Barbara M. Yates, Fred DeKay, and Peter Nickerson, of Seattle University, authors experienced in teaching courses, the manual reviews current issues and applications related to materials in the chapters.

Student Workbook This updated and improved version, written by Ray Olszewski, Michael Block, and Henry Demmert, contains more problems and applications for all chapters, and reviews of each chapter.

Test Item File The Test Item file, by Jack Adams, University of Arkansas, contains approximately 2,000 questions including multiple choice, true/false, fill-ins, and essays on a Computerized Test program, free to instructors on adoption.

We have benefited from the suggestions of many colleagues and other friends. While it is not feasible to mention all of them we do want to recognize the following who helped especially with the basic contents of the book, or in the process of collecting data underlying the analysis. Professor David Teece of the University of California at Berkeley contributed many valuable insights, especially on the new looks in the profession at the internal operations of the

business firm and its interactions with other participants in the market. Robert Highsmith, of the Joint Council on Economic Education, reviewed the entire manuscript for both content and expression, with advice that frequently put a finger on weaknesses whose improvement made the book easier reading and better teaching.

In addition, for their help in the preparation of the manuscript, we thank Christopher L. Bach, U.S. Department of Commerce; Lawrence M. Kahn, University of Illinois; Stuart Low, Arizona State University; Gerald Meier, Stanford University; and Arthur L. Welsh, Indiana University. We are also grateful, for their suggestions and other help, to Sarah Born and Richard Leacy, Georgia Institute of Technology; Conrad Calgaris, Northeastern University; David Huseman, Butler County Community College; Allen Kelley, Duke University; Bruce Kutnick, Northeastern University; Stewart Lee, Geneva College; Craig West, Drake University; Lori Wilson, Stanford University; Francis Shieh, Price Georges Community College; and Deborah Hillman, Gloria Gale Lima, and James Newman.

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GLB
RF FL
JH AL

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Some Foundations and Beginnings

PREVIEW

What is Economics?
Scarcity and Affluence
Problems of the 1980s and 1990s
What Are Our National Goals?
Personal Wants, National Goals, and Priorities
How Shall We Set Our Priorities?
Objectives of Book
Some Suggestions on How to Use the Book
Summary and Review
Some Concepts to Remember
For Analysis and Discussion
CASE 1: Campus Parking
APPENDIX: Economics, Catalytic Converters, and
Pollution

Why do top-ability basketball stars like Larry Bird and Julius Erving receive salaries of over \$2 million a year, and TV stars even more? Why do physician-surgeons earn \$75,000 to \$150,000 on the average, and itinerant fruit pickers only \$3,000? How is it that we in America, by and large, are well fed, well clothed, and well housed while over 2 million people—over two-thirds of the world's population—are desperately poor, living on per capita income of less than \$100 per month? What explains these differences? Why do we have air and water pollution, when almost everyone agrees that we need a cleaner environment? How can we have a better life for all, in the United States and the rest of the world?

These are the questions of economics, these and many others like them. There are no simple answers to most of the questions. But even though economics can't give simple answers to such complex questions, it can go a long way in helping you understand the economic world in which you live and the issues on which you will have to make decisions and vote.

WHAT IS ECONOMICS?

Economics is the study of how the goods and services we want get produced and distributed among us. This part we call **economic analysis**. Economics is also the study of how

we can make the system of production and distribution work better. This part we call economic *policy*. Economic analysis is the necessary foundation for sound economic policy. This book is about both economic analysis and policy.

Another, slightly different definition of economics, favored by many economists, is this: Economics is the study of how our scarce productive resources are used to satisfy human wants. This definition emphasizes two central points: First, productive resources are scarce, in the sense that we are not able to produce all of everything that everyone wants for free; thus, we must “economize” our resources, or use them as efficiently as possible. Second, human wants, if not infinite, go so far beyond the ability of our productive resources to satisfy them all that we face a major problem in “economizing” those productive resources so as to satisfy the largest possible number of our wants. Indeed, most major economic problems arise from this fact of scarcity, and the need to make effective use of our resources to satisfy our wants. If there were plenty of everything for everyone to have without working or paying for it, there would be no economic problem. But alas, this is not the state of the world, even in the affluent American society, and certainly not in the poorer nations that contain most of the world’s people. Hence the title “economics” for this field of study.

SCARCITY AND AFFLUENCE

The United States is an affluent society. We are rich by comparison with other nations. In 1985, the prodigiously productive American economy turned out about \$4 trillion of goods and services, about 25 percent of the total production in the entire world, even though less than 6 percent of the world’s people live in the United States. Table 1–1 shows per capita output of goods and services in the United States as compared with a dozen other nations. Along with several of the Western European democracies, we lead most other nations by a wide margin. Our lead over the so-called developing countries is enormous. (Such international comparisons are very rough, and the ranking depends on the measurement method used, but they suffice

Output Per Capita in Different Nations, 1982–1984†

TABLE 1–1

U.S.A.	\$16,400	USSR	\$2,670*
Switzerland	14,000	Brazil	2,230*
Sweden	11,370	Mexico	2,300*
Japan	10,460	Indonesia	580*
W. Germany	10,100	India	240*
United Kingdom	7,500	China	220*
Italy	6,110	Zaire	180*
Israel	6,010	Bangladesh	140*

* Rough estimates for 1982 provided by the United Nations.

† Estimates for all other nations are provided by the Organization for Economic Cooperation and Development and are for 1984. Estimates are based on official foreign exchange rates for most countries and probably understate substantially the level of output in the poorer, “developing” nations. More details and estimates for other nations are provided in Chapter 42.

to suggest orders of magnitude. We will examine them in detail later.)

In 1985, the median family income in the United States was about \$24,000; half of all families received more and half less than this amount of income. (This is considerably less than output per family, because a large amount of total production goes into building factories, replacing worn-out productive machinery and housing, and the like. This production is not directly income to families. It is more than the average income per worker because many families include more than one worker.) But not all Americans are affluent. Figure 1–1 shows the distribution of income in America in 1984. About 13 percent of all families were classified as “poor” by official government statistics; a typical four-person family living in a city was considered poor if its income was \$10,600 or less. By contrast, the average income of about half the world’s population, about 2 billion people, was less than \$200; but the proportion of poor was considerably less if the aid given by government payments to the poor was added on to the people’s privately earned incomes.

What did our huge gross national product of nearly \$4 trillion in 1985 include? We produced one-half billion loaves of bread and 160 billion passenger miles of air travel; about \$3 billion worth of books, \$6 billion worth of

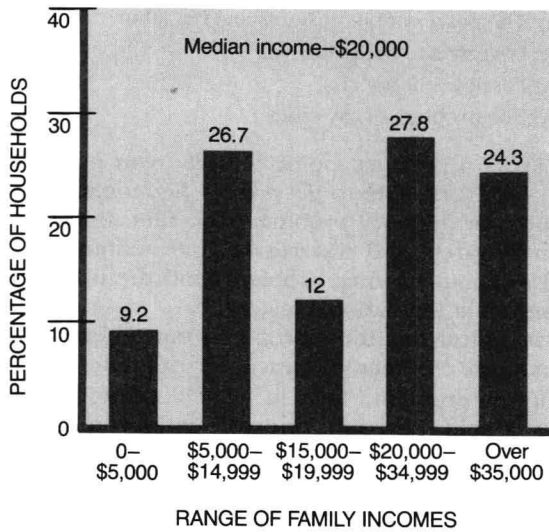


FIGURE 1-1

Family Incomes in 1984

The United States has a wide range of family incomes. Each bar represents one-fifth of all families. Half got more than \$20,000, half less. (Source: U.S. Department of Commerce.)

frozen fruits and vegetables, \$3 billion worth of toys and games, \$180 billion worth of health services (over \$3,000 per family), and about \$100 billion worth of educational services. The auto industry turned out about 11 million cars, bringing the total on the road to over 100 million. We built 2 million new housing units, and over 95 percent of all existing housing had inside plumbing, a rarity in most of the world's nations. The economy provided over 100 million jobs, an increasing proportion of them in retail and wholesale trade, government, and other *service* occupations, in contrast to *agriculture* and *manufacturing* jobs. Figure 1-2 presents a summary picture of what has happened to the composition of jobs in the American economy over the past century; the total number of jobs over the same period has risen by over 500 percent, from about 18 million in 1869.

With all this productivity, the American economy has also produced some of the world's largest slums in our central cities, widespread air and water pollution that threatens our health

FIGURE 1-2

The Changing Patterns of Jobs

The past century has seen a dramatic change in the way Americans earn their livings. Less than 25 percent now work in manufacturing, nearly 70 percent in service industries. Note the decline in agriculture. (Sources: National Resources Committee and U.S. Department of Commerce.)

