ELEMENTS OF ECONOMICS

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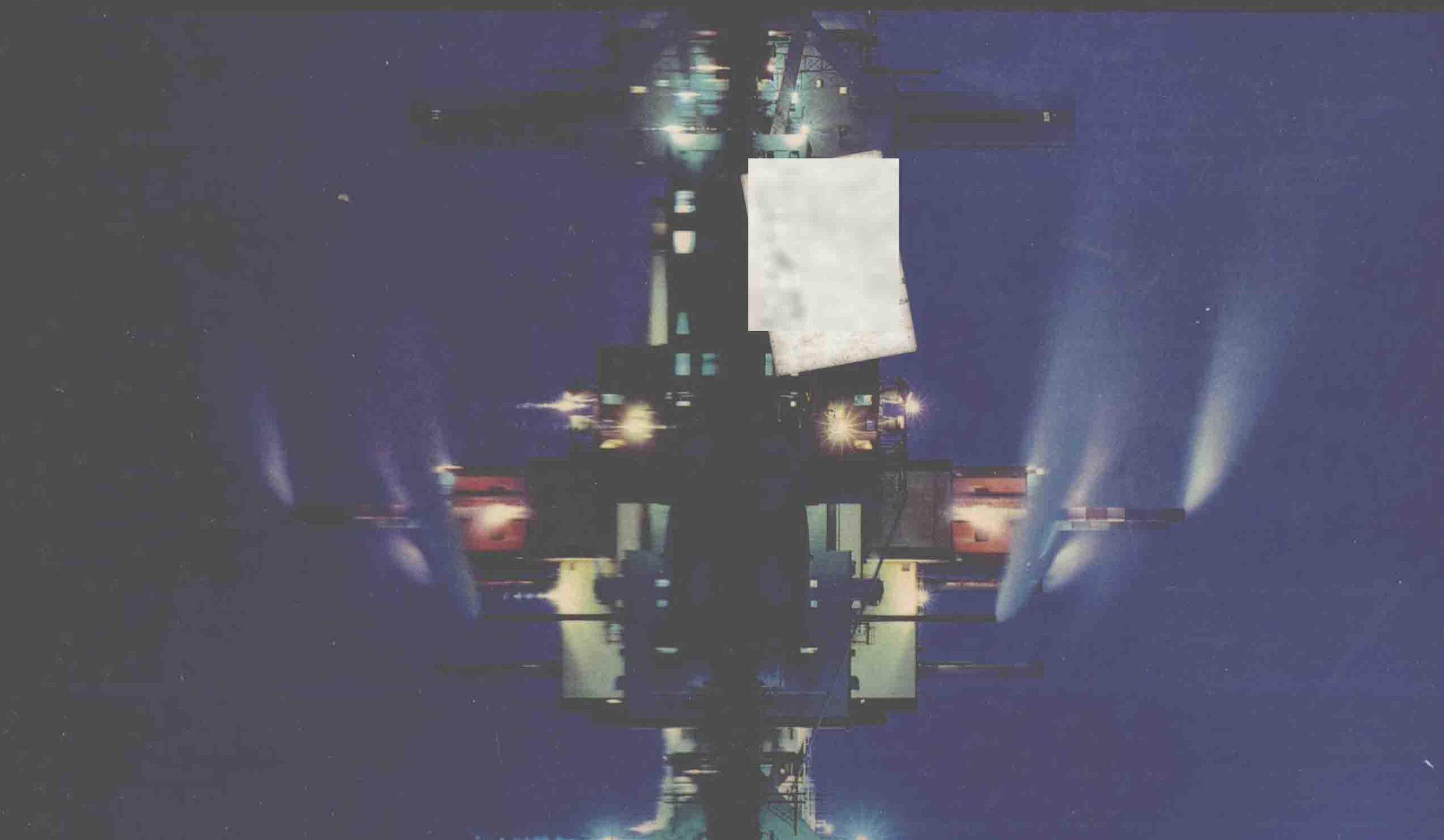

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ELEMENTS OF ECONOMICS

Preface

Economic theory, we believe, is a body of thought with clear applications, a tool that can be used to explain and predict economic phenomena. Governments use these explanations and predictions to try to control economic conditions (such as unemployment, inflation, and pollution) and to improve the standard of living. Throughout this book, we emphasize the practical applications of economic theory, while at the same time indicating the complexity of economic problems.

This text surveys the economic issues that confront all societies—how to achieve affluence, economic stability, and an acceptable distribution of income. Economics provides (1) concepts that help us understand how economies work, (2) a perspective on the roles played by the public and private sectors, and (3) insights for solving economic problems. It is an exciting field. We are dealing with some of today's most pressing problems: unemployment, inflation, pollution, economic growth, poverty, inequality, discrimination, and the efficiency of the private sector relative to the public sector.

The field of economics does not, however, offer definitive solutions to these problems. Economics is a social science; its principles are axioms about the behavioral tendencies of individuals and groups. It is not a science of great precision; unlike the law of gravity, its "laws" cannot be readily verified. An economy is so complex, so intertwined with the economies of other nations, so affected by the factors that shape people's economic behavior that precise predictions about economic phenomena are usually impossible. It is clear to economists—and it soon becomes clear to students of economics—that in this profession there are no sages, no one who has all the answers. Students will soon realize that economics must operate in the context of a political decision-making process. Solutions to existing problems may be different from those thought appropriate a decade ago. Economic theory is a dynamic body of thought that enables us to conceptualize broad issues and problems—a body of thought that is pushed continually to new frontiers as we endeavor to learn more about economic relationships in society.

Our experience as teachers of economics tells us that many students of introductory economics simply memorize facts, neglecting the processes necessary to an understanding of the material. After an examination, for example, some students—particularly those who only memorize facts—find themselves with test scores lower than they expected. In this regard students will find it helpful to use the Study Guide designed to accompany this text. The Study Guide includes projects and problems as well as sample true/false and multiple-choice questions with detailed answers.

Many economists have contributed directly and indirectly to the writing of this book. We appreciate the cordial and productive working environment provided by our colleagues at The Florida State University. We are also grateful to the following reviewers for their insightful comments and suggestions: David Abel (Mankato State University), Richard C. Cahaan (Ohio State University), Daniel Gropper (Florida State University), Randolph Martin (University of South Carolina), Robert Michaels (California State University), G. R. Miller (Morehead State University), Sidney Wilson (Rockland Community College), and H. Zabinsky (Loyola University).

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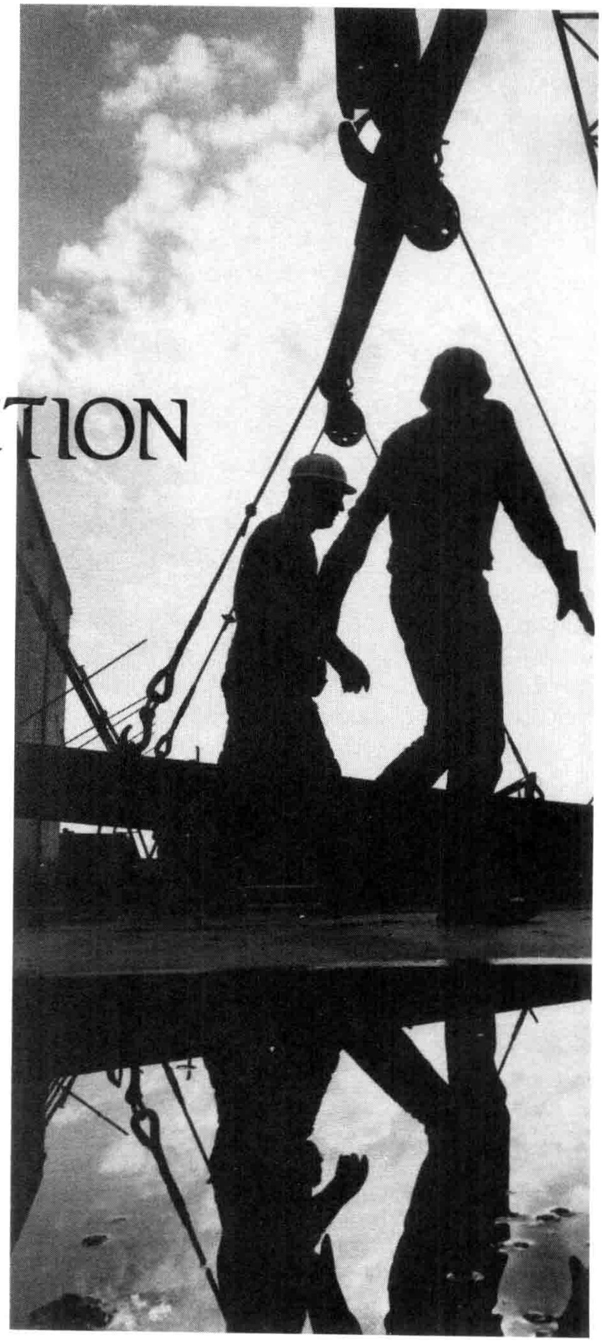
INTRODUCTION



Chapter 1

What Is Economics?

"Why should I study economics?"

This is usually one of the first questions raised by a beginning student in an introductory course in economics. It is a simple question that has several answers.

One major reason to study economics is to become a better-informed citizen. A knowledge of economics helps you understand economic questions facing the society and to evaluate the statements of political leaders on economic matters.

The study of economics also helps you to understand other societies besides the United States because economics deals with universal problems. Every society must decide what to produce, how to produce it, and who will receive the benefits. Many principles are the same, whether in the United States or elsewhere.

Perhaps the least helpful definition of economics is the tongue-in-cheek observation, "Economics is what economists do." Fortunately the activity of economists can be summarized in a more helpful way. Economics is the study of (1) the way societies choose to allocate scarce resources among alternative uses, (2) the way they distribute the fruits of production among various individuals and groups, and (3) the sources of economic growth and the causes of fluctuations in economic activity. Rather than continue to define economics in general terms, let us show the relevance of economics by discussing some of the issues covered in this book.

THE RELEVANCE OF ECONOMICS

How Do Markets Work?

The economy of the United States uses what is called the market system to allocate its production of goods and services. There is no central council or board of planners to decide who manufactures what, or how much of it, or who buys it at what price. Yet many economic wants are satisfied. People in Chicago go to the supermarket confident that they can buy oranges grown 1000 miles away. Florida growers cultivate their trees hoping that people they have never seen will buy the fruit and that the growers will make a profit. Decentralized decision making is characteristic of the market mechanism.

Individual workers in a market economy seek to perform those tasks which yield them the highest reward. Business firms produce goods or services that will maximize their profits. In their search for "best advantage," individual business firms within the market system produce commodities that people are willing and able to purchase, and in the process they organize production. Growing oranges requires many different people and products before the fruit can be bought by the consumer. Florida growers must buy fertilizers and sprays from chemical manufacturers hundreds of miles from the groves. Ladders may be "imported" from Tennessee, crates and boxes from Washington or Georgia, and sprayer equipment from California. Those who pick the crops may come from as far away as Maine. Trucks deliver the oranges to wholesalers who in turn sell them to super-

At the supermarket, shoppers make choices that help determine how profitable the production of various foods is. *(Photo by Richard Kalvar, Magnum Photos, Inc.)*

markets. In the stores, local workers unpack and price the fruit before the final consumers purchase it. Self-interest directs the behavior of each person in this chain, yet their conduct benefits the consumers as well. As Adam Smith, who first elaborated the workings of the market mechanism, noted, "It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantage." The study of how markets work belongs to the branch of economics called *microeconomics.*

The fact that individual self-interest can produce a social good is a paradox of this form of organization. Yet, while unplanned markets work reliably in bringing oranges from the groves of Florida, Texas, and California to households all over the nation, in other circumstances they do not work at all. For instance, they do not work in national defense. Most Americans are willing to pay for a commodity called national defense in order to guard against a possible attack by a foreign power. Yet no private business firm offers to "sell" this protection. Providing national security and growing oranges both require productive resources, yet the government supplies national security while the private market mechanism organizes the production of fruit. Economics analyzes the circumstances under which private markets work well and those under which governmental organization seems superior. Such questions are basic to economics, a discipline not without controversy.

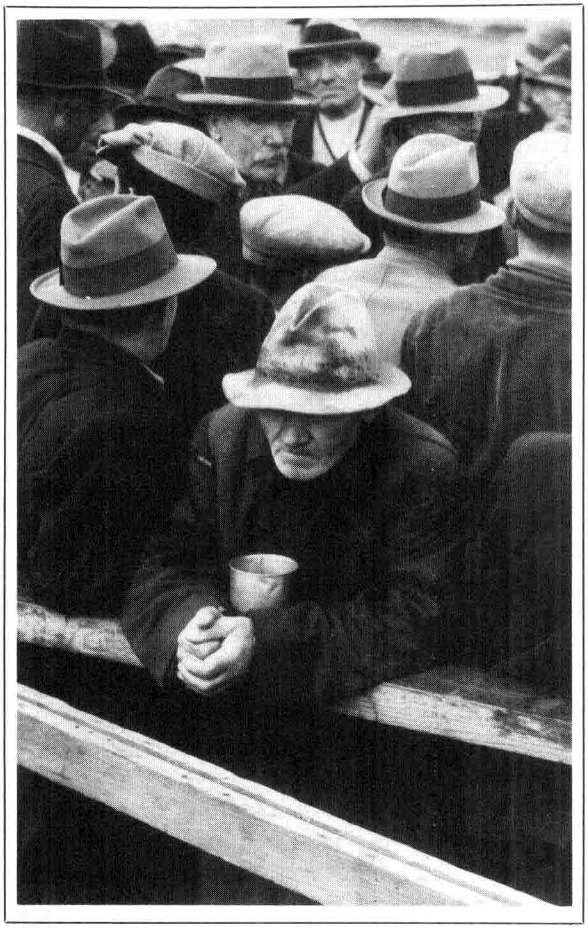
Can We Avoid Unemployment and Inflation?

A modern economy such as ours is subject to periodic fluctuations, in which the production of goods and services declines. In human terms, the most painful consequence is that some people wishing to work cannot find jobs. The most dramatic decline in economic activity was the Great Depression of the 1930s. In 1929 President Hoover took office with a pledge to eliminate poverty in the United States only to find himself, three years later, presiding over a crippled economy. Man-hours of work in manufacturing fell 45 percent between 1929 and 1932. National income declined from $87 billion to $39 billion. At the depth of the depression, one of every four workers was out of a job.

How could the Great Depression happen? The factors that account for production—land (which includes all natural resources), labor, and capital—were intact. Capital—the machines and buildings that raise the productivity of workers—was idle while people sought work, yet somehow the two could not be combined into a productive process. People wanted to work, employers preferred to have factories in operation so they could make a profit, raw materials were available; yet the economic system floundered as abysmally as its most severe critics had ever predicted.

What does a decline in economic activity really mean? The effects are far more dramatic than economic data suggest, for cold statistics cannot reflect the resulting human suffering. In his oral history of the Great Depression, Studs Terkel reports a psychiatrist's impressions of miners during the 1930s:

> I did a little field work among the unemployed miners in Pennsylvania. Just observing. What the lack of a job two, three, four, five years did to their families and to them. They hung around street corners and in groups. They gave each other solace. They were loath to go home because they were indicted, as if it were their fault for being unemployed. A jobless man was a lazy good-for-nothing. The women punished the men for not bringing home the bacon by withholding themselves sex-



For many people, the lack of jobs during the Great Depression led to not only hunger but also psychological depression. *(Photo by Dorothea Lange, Magnum Photos, Inc.)*

ually. By belittling and emasculating the men, undermining their paternal authority, turning to the eldest son. Making the eldest son the man of the family. These men suffered from the depression. They felt despised, they were ashamed of themselves. They cringed, they comforted one another. They avoided home.*

*Studs Terkel, *Hard Times: An Oral History of the Great Depression* (New York: Pantheon, 1970), p. 196.

In the late 1970s and early 1980s, inflation—the rising prices of goods and services—joined unemployment as a substantial and persistent economic problem. When the general price level rises, the purchasing power of the dollar falls. Each dollar we hold will buy fewer goods and services. In 1979 the price level rose by 13.3 percent, and the following year it rose another 12.4 percent. Over the span of two years prices rose 25.7 percent. By the end of 1980, a dollar bought only three-quarters of the amount it could buy at the beginning of 1979.

A major portion of the economics discipline, called *macroeconomics* because it is concerned with the entire economy, is directed to the study of economic growth and instability. Macroeconomics has a public-policy orientation that focuses on three distinct but related goals: sustaining a desired rate of economic growth, maintaining stable prices to avoid inflation, and keeping unemployment as low as possible. Achieving these goals would greatly increase our national economic well-being.

How Is the Distribution of Income Determined?

One of the issues facing the United States is the unevenness with which the national income is distributed. The U.S. Census Bureau's official definition of poverty is based on a food budget designed for "temporary or emergency use when funds are low." Such a budget by definition does not meet the basic needs of a family over an extended period; yet it represents a level of existence that many families and individuals do not attain. In 1980 25.3 million persons were living in poverty in the United States—11.2 percent of the population! The outstanding feature of the poverty profile is that many poor people are not able to improve their economic status. Over 8.4 million persons under the age of 15 lived in poor families in 1980; almost 3.6 million people