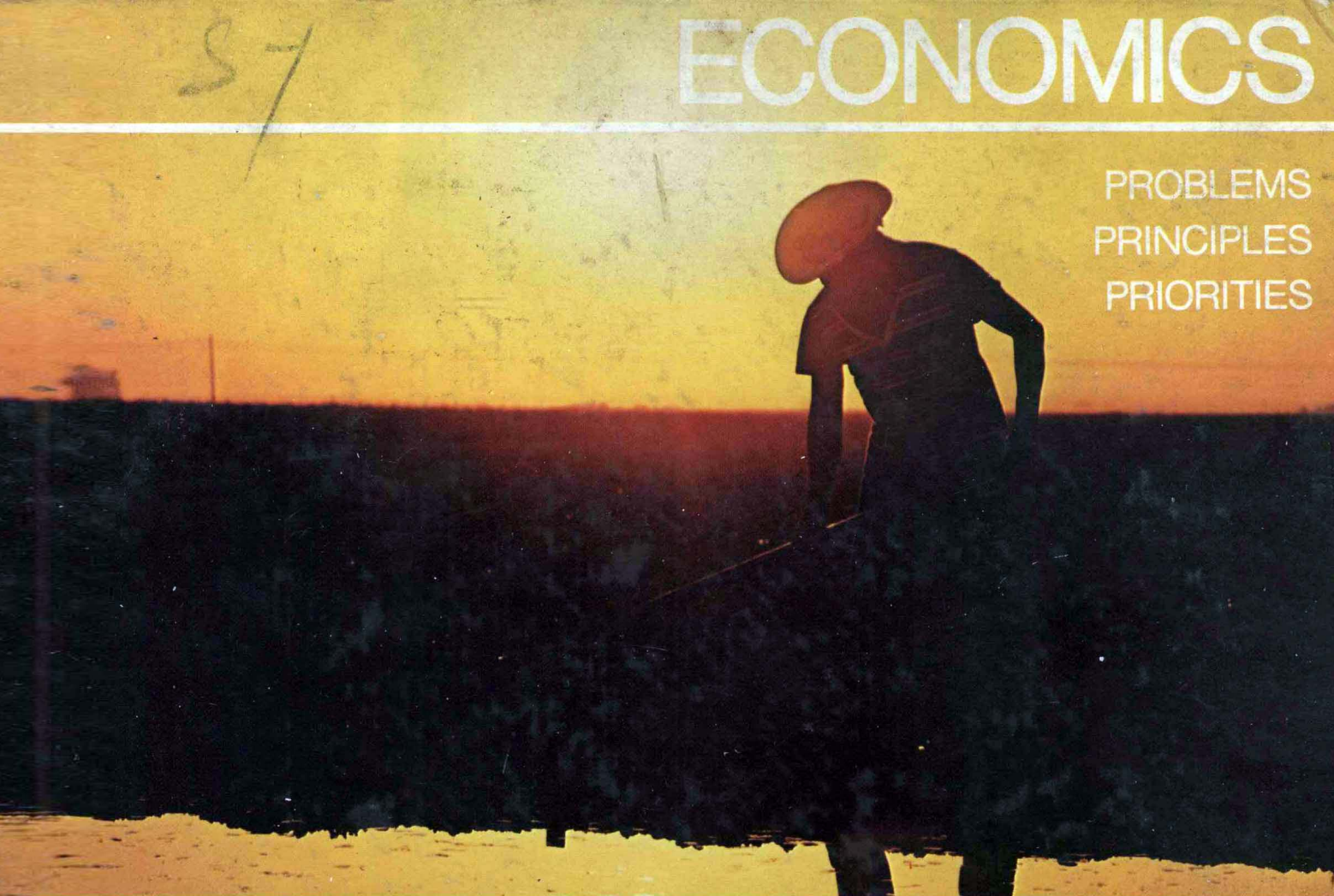


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ECONOMICS

PROBLEMS
PRINCIPLES
PRIORITIES



Fredrick L. Golladay

ECONOMICS

Problems, Principles & Priorities

FREDRICK L. GOLLADAY

World Bank



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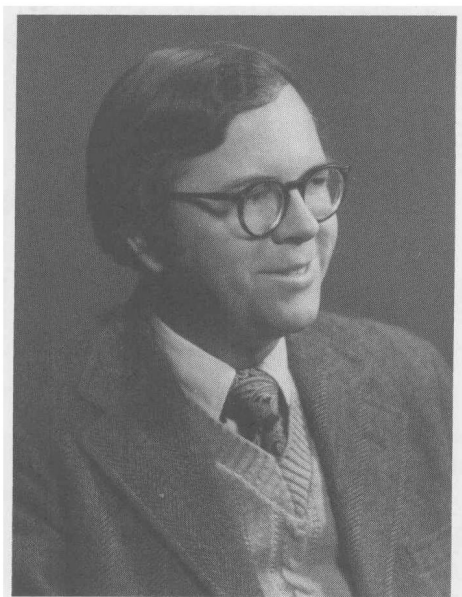
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ABOUT THE AUTHOR

Fredrick L. Golladay received his Ph.D. in economics from Northwestern University in 1968. He taught at the Chicago Campus of Northwestern in 1966 and 1967, and from 1968 through 1974 he taught at the University of Wisconsin—Madison. While at the University of Wisconsin he was on the staffs of the Center for Development, the Health Economics Research Center, the Social Science Research Institute, and the Institute for Research on Poverty. In 1974 he joined the World Bank where he was first in the Development Policy Staff's Development Economics Department. He is presently health economist on the Project Advisory Staff of the Bank. Dr. Golladay has published articles on manpower policy, the economics of health, transfer policy and regional economics in journals including the *American Economic Review*, *Operations Research*, *Journal of Human Resources*, *Medical Care*, *Inquiry*, and others. He is coauthor with Robert Haveman of *The Microeconomic Effects of National Transfer Policies*. He has been an advisor to several agencies in the U.S. Department of Health Education and Welfare, and to a dozen developing countries—of every political hue. He is now also special consultant to the National Academy of Science and the World Health Organization. He has contributed to international conferences on the economics of disease in developing countries, social development, educational planning, and health policy.

PREFACE

Features of the Book

This book is written for all students of economics, including those who have registered for economics under duress, hoping never to enroll in another economics course. Even with the highly gratifying growth in the popularity of principles courses, only a tiny fraction of any class has, at the outset, any intention of pursuing economics as a major or even taking a more advanced course. The first task of the introductory course must, therefore, be to provide all students with something of lasting value. I believe this something should include an “instinct for the problem of scarcity,” an appreciation for the importance of market institutions in mediating economic problems, and a commitment to rational problem solving and analysis. The second responsibility of the course is to give students who might be (or become) interested in taking more advanced courses a sense of what the discipline is about and particularly to suggest further areas of study. Ideally the course should tease the appetite rather than overwhelm. The third function is to lay the foundations for further areas of study. In my opinion, this does not mean mere mastery of the jargon of economics nor even the ability to manipulate simple models. Instead, it implies developing a strong sense of the problems that occupy the attentions of economists and a commitment to painstaking, rigorous analysis.

In this book I have introduced a number of devices that have proved highly useful in pursuing these goals. At the same time I have striven to avoid being trendy or attempting to revise economic theory; anyone who has used any of the basic, earlier texts will be comfortable with the organization and language employed here. The distinctive features of the book are concerned with its emphasis and pedagogy. Consequently, they may not be obvious at first glance, but they will be apparent when the book is used.

- I have sought to introduce every analytic tool by a familiar and concrete problem. Few things are as baffling or leaden as abstract theories that do not grow immediately out of a real-world situation. I have resisted

the temptation to first present an analytic tool and *then* apply it. This time-honored approach deprives the analysis of the sort of context necessary to grasp its significance or usefulness and, in addition, too often encourages frivolous application of economic theory. As a result, students tend to doubt whether all the graphs, equations, and symbols really contributed anything to understanding reality.

- I have disassembled theory into the smallest possible units in order to minimize distance between the introduction of an issue and the first fresh, new insight. In avoiding the temptation to present an entire model before exploring it, I have recognized the low tolerance of students for extended, abstract arguments and analyses.

- I have attempted to capitalize on the sense of *excitement that is obtained from conquering a problem*. Major topics are frequently introduced by working through the historical development of analysis. This is by no means intended to be a history of economic theory. But, by tracing the development of ideas, it is possible to illustrate the way in which economic understanding is achieved and to introduce concepts bit by bit. Students are thereby given at least a peek at how theories are formulated, tested, and used well.

- I have drawn on a very wide selection of *supplementary essays*. The essays are intended to relieve what for many students will still be the tedium of formal analysis and, as importantly, to convey a sense of the great diversity of concerns that typifies modern economics. I have included excerpts from literature, philosophy, mathematics, current affairs, political science, engineering, and social criticism that will appeal to a variety of students and will enable them to relate their major interests to economics as well.

- Throughout the book I have repeatedly worked through *the steps of scientific inquiry* in order to reinforce the notion of *rational problem solving* and to underscore the usefulness of systematic, rigorous analysis. An entire chapter is devoted to the philosophy of science and methodology. The very least that a student should retain from reading this book is an instinct for approaching problems rationally.

- I have ruthlessly excluded terms and concepts that cannot be employed in conspicuously useful ways by the student of an introductory course. Few things are as unpalatable as inert knowledge, and I have actively sought to exclude those ideas that are incapable of proving their worth immediately.

- I have developed all major concepts at several levels of abstraction and sophistication in order to preserve an *intuitive sense of the issues* being pursued. This means that the initial statements of ideas are incomplete and imprecise. But because notions are elaborated in spiral steps, the student is spared the common horror of getting lost. Probably the single greatest obstacle to economic literacy has been the tendency to conceal the larger picture by too much detail presented too soon.

- Finally, I have placed greatest *emphasis on the uses of economic analysis*. This preoccupation is most clearly reflected in the Topics for Discussion at the end of each chapter. Avoiding the recitation of chants and regurgitation of terms, I have instead posed problems of application of the tools developed in the chapter. This feature most clearly portrays the distinctive intent of the book, as a comparison with any competing text will show. Through *structured* discussion of topics such as these, it is possible to drill terms and concepts and in *addition* to develop skills in analysis and problem solving.

The Supplements

This book is accompanied by an unusually extensive package of teaching materials that, like the text, reflect an emphasis on the development of basic skills. The **Instructor's Manual** provides a discussion of the rationale for the organization of each chapter, a brief outline of the contents of the chapter, lecture materials, and further ideas for discussion sessions. I have used the Instructor's Manual to present ideas that limits of space prohibited me from including in the text. It is my hope that lecturers and discussion leaders will find the Manual useful in tailoring the text to the particular interests and tastes of their students. I am convinced that only through face-to-face contact with students is it possible to infuse real life into economics and to motivate the subject. A **Study Guide** is also available which summarizes the text material from a fresh perspective and provides opportunities for self-testing and drill of important concepts. Finally, a **Test Bank** is available which is scaled for difficulty and targeted level of understanding.

This book represents many years of accumulating examples, searching for engaging applications, and seeking to reduce economic analysis to digestible mor-

sels. It is *not* a handbook of economic theory or an encyclopedia of economic concepts. There are more exhaustive and more detailed books already on the market. But for those who share my belief that economics is a lively, engaging subject, better viewed as a way of thinking than as a bag of cumbersome tools, here is the book.

The Split Version

This book was written for use in two-term courses in introductory economics. It is available as two paperbound books: *Microeconomics* and *Macroeconomics*. Part 1 of the main text appears in both paperbound volumes. It provides a very rapid survey of the entire subject and introduces its language and methodology. Parts 2 through 5 cover microeconomics, and Parts 6 through 10 present macroeconomics.

Microeconomics is introduced prior to macroeconomics in the hardbound version in deference to the growing interest in the microeconomic foundations of macroeconomics. The ordering of micro- and macroeconomics is not important at the level of sophistication of the book, but does become significant if the instructor wishes to expand further in lecture on recent theories of inflation and unemployment.

One-Semester Courses

The book is designed to be used in one-semester courses as well. Several options are available. The following are only suggestions.

One-semester course—*macroeconomic* emphasis:

- Part 1: Chapters 1–6
- Part 2: Chapters 7, 9–13
- Part 6: Chapters 23–26
- Part 7: Chapters 28–31
- Part 8: Chapters 33–35
- (23 chapters total)

One-semester course—*microeconomic* emphasis:

- Part 1: Chapters 1–6
- Part 2: Chapters 7–12
- Part 3: Chapters 13, 15–17
- Part 4: Chapter 18
- Part 6: Chapters 23, 25–26
- Part 7: Chapters 28–30
- (23 chapters total)

Acknowledgments

This book is the product of many years of thought, experimentation, and research. A large number of people have contributed to its development, not the least of whom are the several thousand students who have made teaching a challenging and exciting experience. I would like to acknowledge many teaching assistants who have shared with me the task of clarifying goals of the course and in discovering that teaching is a rewarding enterprise: Jean Behrens, Anna Craig, Martin Dooley, John Gambill, William Hymen, Gary Keyen, Charles Knapp, Marilyn Moon, Paul Nelson, Henry Raimondo, Valerie Samartino, Robert Schenk, Irene Waldman, and Stephen Weber.

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The book has benefited greatly from the careful comments of the following reviewers, who read all or major portions of the manuscript:

Richard K. Anderson
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They, of course, are not responsible for remaining errors and defects.

Final touches have been added to the manuscript since I joined the staff of the World Bank. My colleagues and experiences at the Bank have contributed a great deal to my understanding of the uses of economics. However, neither the Bank nor my colleagues bear any responsibility for the final product; the ideas expressed are entirely my own.

I would like to thank Richard Fenton and Derek Holman for the encouragement and keen insights they have provided.

Fredrick L. Golladay

TO THE READER

Before you begin this course—and this book—I would like to offer some observations and a few bits of advice that should prove useful and that may increase your enjoyment of the subject. Economics is perhaps the most commonplace subject you will ever study. All of us are caught up to some extent in the business of life: earning, spending, and investing in an uncertain future. Most people survive the struggle without the benefit of a course in economics, but I am certain that you will find the challenge of survival a bit less difficult if you understand how the system works. Getting ahead is only one reason for studying economics, however, and the others may prove even more rewarding. Although economics is indeed concerned with our material welfare, it is also a *social science*, preoccupied with the question of how we as members of society sort out our differences. Understanding the economic system provides a valuable framework for considering social problems ranging from racial discrimination to international politics: Whether you aspire to the U.S. Senate or a quiet life in the suburbs, knowledge of the economy will be useful. A dominant goal of this book is to give you some sense of the place of economics in your life.

This book has been developed to make learning as painless as possible. Even so, there is work to be done. However, you should find the going a little easier if you understand how the book is organized and how it is intended to be used. The greatest obstacle to understanding economics is its complexity. Anyone who attempts to understand it bit by bit is doomed to failure and frustration. It is important to get the larger view before attacking the details. The book is organized to make this easy. Part 1 and the opening chapters of later parts provide overviews of the subject. Read them even if they are not assigned; they will make the rest of the book much more manageable. In addition, every chapter is followed by a brief summary of the contents of the chapter. You will find that everything covered in the chapter is contained in the Chapter in Brief, but it will be profitable to read the chapter for the perspective and insight offered. I suggest that you read each chapter quickly, then study the Chapter in Brief. Rereading the text

should then be like revisiting an old friend. For review, the Chapter in Brief should suffice.

The second obstacle to understanding economics is that it frequently appears easier than it is. Economics has been described as common sense but of a very uncommon sort. Finding an argument easy to agree with is not enough. You must struggle through a few problems yourself to be certain that you understand how to use economic principles. The Topics for Discussion at the end of each chapter provide a few points of departure for testing your understanding. In addition, I suggest that you take a problem from the day's newspaper and attempt to analyze it as well. Above all, be sure that you don't allow yourself to rely on uses of economics that have already been worked out for you. Struggle with a few problems to be certain that you understand; don't just settle for finding arguments plausible.

A third bit of advice: Look for fresh applications of economic analysis that are useful to you. What are job prospects for your chosen occupation? How will growing prosperity affect your prospects for attaining your economic goals? How does the mounting complexity of modern society influence the role of government in your life? Probe for ways of using economic knowledge that make the course worthwhile to you, and then press your instructor to help you in applying your newly gained knowledge.

Finally, avoid the temptation to dismiss difficult ideas as being only for the "professional" economist. Skipping over problem topics will eventually create difficulties that are hard to overcome. If you don't understand an argument or its significance, ask your instructor to explain it. Chances are that many others in the class are having problems with the same topic and that your instructor will be pleased to help you.

The Study Guide available to accompany this book provides additional, specific aids to understanding economics. Even if your instructor does not assign it, I suggest that it will prove to be a valuable investment; your bookstore will be happy to obtain a copy for you. It expands the discussions of the most difficult ideas and offers many opportunities for self-evaluation. Good luck; I hope you enjoy this course.

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