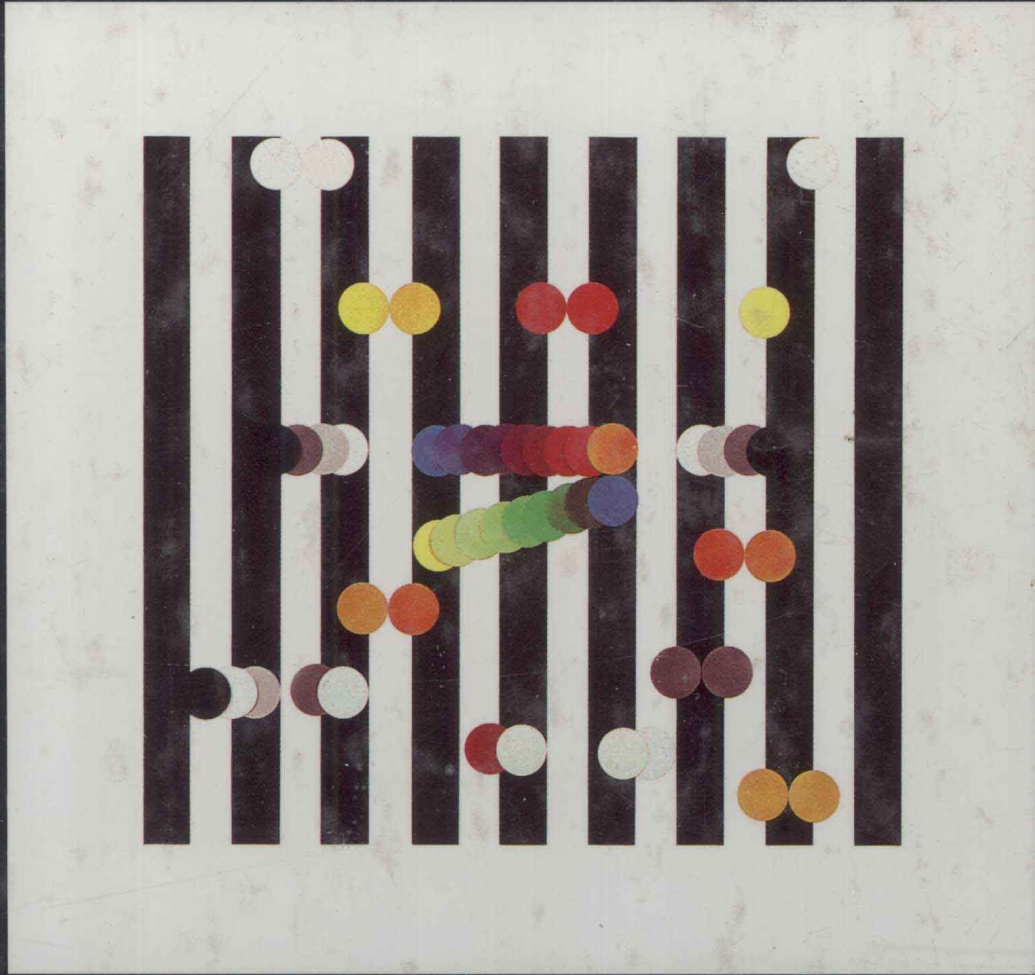


# BASIC ECONOMICS

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**8TH EDITION**

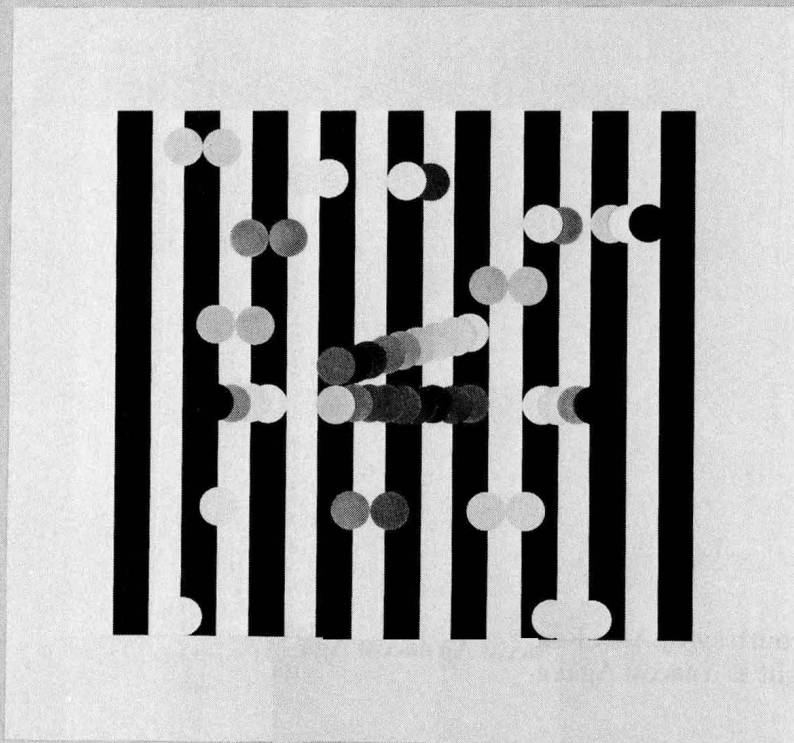


**HAILSTONES**

●  
**MASTRIANNA**

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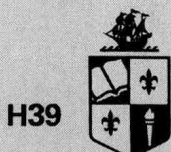


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Each year seems to generate greater interest in economics. Our fast-paced lifestyle and world-wide political and economic events have generated more excitement about economics. In the past dozen years we have experienced double-digit inflation, food shortages and surpluses, tax cuts and tax increases, high and volatile interest rates, record federal deficits, a taxpayers' revolt, a flood of imports, and a host of other domestic and international events that have affected our daily lives.

The questions of why and how, the analysis of existing conditions, and solutions to economic problems are discussed in schools, homes, offices, workplaces, featured on television, and debated in the halls of Congress. To understand many of the social, political, military, and economic problems and issues of our society, it is necessary to know more about the nature and function of our economic system.

*Basic Economics* is intended to give the reader a basic understanding of the operation of our economic system; to explain the roles of demand and supply in determining prices, to compare the merits of competition vs. monopoly, and to explain the use of antitrust regulations; to demonstrate the role of money and its effects on our economy; to present a measurement of production, employment, and income; to show the current methods of economic analyses and the development of both demand-management and supply-side economic policies that are used to stabilize the growth of economic activity; and to relate international economics to our domestic economy. In short, the book endeavors to take the reader from scratch through a relatively high level of economic analysis in one term.

*Basic Economics* deals with both micro- and macroeconomics. For *microeconomics*, it treats the pricing mechanism, the role of demand and supply, elasticities of demand, competitive vs. monopolistic pricing, and the need and purpose of antitrust regulation. From the viewpoint of *macroeconomics*, the text deals with concepts of the economy as a whole, such as total production, employment, income, recession, and inflation, rather than with the problems of the individual or the firm.

The text is designed for a one-term course at the college level and primarily for those students, such as preprofessional, business, liberal arts, and agriculture, who will take only one course in economics. It may also be used for an introductory course for economics majors and is likewise suitable for a survey course for graduate students. In addition, the text has also been used successfully for teaching economics in management development programs.

Each chapter ends with a list of new terms used in the chapter and

review questions that are also suitable for classroom discussion. In addition, there is a glossary, along with the index, at the end of the book for quick student reference.

A *Study Guide* is also available for student use. It contains such related materials as detailed economic data, economic problems, topical readings, and objective questions for each of the textbook chapters. The *Study Guide* is designed to enrich the student's understanding of economics and enhance achievement on examinations.

An *Instructor's Manual* accompanies the text. It contains more detail about the purpose, teaching suggestions, and discussion questions for each text chapter. In addition, it includes a bank of examination questions for each part of the text. These questions may be used, if desired, to test student achievement.

For the eighth edition of *Basic Economics*, all factual and statistical materials has been updated and/or expanded. New graphs have been inserted to illustrate scarcity, production possibilities, tariffs, and international exchange rate determination. In addition to the usual treatment of inflation, the eighth edition covers disinflation and deflation, and their effects on the economy. Other new topics include privatization, banking reform, monetarists vs. fiscalists, the role of nonbank banks, the decline of union membership, and the deficit reduction act.

Numerous comments have been received from professors and students who used earlier editions of *Basic Economics*. Many of these included suggestions for additional materials in the book. Although much has been added over the years, we have resisted enlarging the volume significantly through careful pruning of some topics and effective consolidation and integration of others.

We wish to thank not only those who assisted with the first seven editions, but also those who offered suggestions for improvement of the eighth edition of *Basic Economics*.

Thomas J. Hailstones

Frank V. Mastrianna

## ABOUT THE AUTHORS

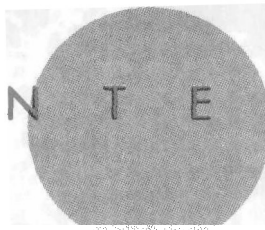
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# **PART 1**

## THE ECONOMIC SYSTEM

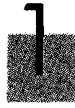


**1 THE NATURE AND SCOPE  
OF ECONOMICS**

**2 THE PROCESS  
OF ECONOMIZING**

**3 OUR ECONOMIC SYSTEM**

**4 THE CIRCULAR FLOW  
OF ECONOMIC ACTIVITY**



# THE NATURE AND SCOPE OF ECONOMICS



Every day it becomes more apparent that economics plays a major role in our lives. Our decisions on what profession to enter, where to work, and where to live are based in large part on economic considerations. If we own a business, economic factors dictate whether or not we earn a profit and continue to operate or fail and go into bankruptcy. Economics applies directly to the earning of our incomes and to the spending of our money. Aside from the direct application of economics to our lives, we are also affected indirectly. Economic policies help determine the level of production and employment in our nation, the amount of taxes we pay, how much aid we give to developing nations, and how much of our resources we devote to preserving our natural environment. Economic measures influence the prices we pay, the purchasing power of our dollars, the availability of goods and services, and our standard of living.

## ECONOMICS DEFINED

Economics means many things to many people. To some it means thriftiness, but to others it means the arranging of a large mortgage loan. To some it implies budgeting for household purchases or saving for an automobile, but to others it means the analysis of a multimillion dollar income statement. To the President of the United States it means the study of economic conditions of the nation, the presentation of a \$1,000 billion plus federal budget, and the proposal of various economic measures that will maximize total production, employment, and income for the nation. The ubiquity of economics offers a challenge to the scholar in deciding where to begin the study of economics. As with any study, a logical place to begin is with a definition, since it serves as a point of departure for explaining, examining, and analyzing the various aspects of the subject at hand. For our purpose, we shall use the following definition: **Economics** is a science that is concerned with the production, distribution, and consumption of goods and services.

## Economics Is a Science

We must keep in mind the fact that a **science** is an organized body of truth coordinated, arranged, and systematized with reference to general laws or principles. Frequently when one thinks of science, one thinks of the physical sciences, such as physics, chemistry, and biology. There are also, however, nonphysical sciences, which include philosophy, mathematics, psychology, politics, and economics. Economics is considered to be a science because it is an organized body of truth coordinated, arranged, and systematized with reference to certain general laws and principles.

Unfortunately the laws and principles of this science, economics, are not so universal or ironclad as the laws of the physical sciences. For example, physics gives us the law of gravity. From this law you know that if you hold this book 2 feet above the desk and then release your grip, the book will fall to the desk. You could try this experiment for hours on end and you would get the same result each time. The law of gravity is, therefore, a universal law that will hold in all similar circumstances.

In economics we do have a few universal laws, such as the law of diminishing returns. According to this law, if all factors used in production are held constant except one, and if this factor is increased a unit at a time, the size of the increments of output resulting therefrom will eventually diminish. Likewise, the laws of supply and demand state in part that when demand increases and supply remains constant, the price of a commodity will increase. Many other laws in economics are only general—not universal, for they apply in most instances but not in every case. For example, the law of consumption states that as the real income of a family or individual increases, the percentage of income spent on consumption will decrease. This is generally true. Most of us, as our real income increases, will save a larger percentage of our income and, as a result, the percentage of our real income spent on consumption will decrease. Every tenth individual, however, might spend more than is earned regardless of how much that person's salary increases.

In the physical sciences we know what reaction to expect when we apply a certain stimulus to a given set of conditions. In economics, where we are dealing with individuals, the circumstances may never be exactly the same because of differences in personality, environment, IQ, and other factors. Consequently, it is more difficult to develop hard and fast laws, and the study of economics becomes more difficult and complex.

## Economics and Production

In economics we define **production** as the creation or addition of utility. **Utility** is our term for usefulness. It is the ability of a good or service to satisfy a want. We are producing whenever we make a product or render a service that is useful. The four most frequently recognized utilities are (1) form, (2) place, (3) time, and (4) possession. Form utility applies to



products, which are tangible in nature, but not to services, which are intangible. The other three forms of utility apply to services as well as to products.

**Form Utility.** **Form utility** occurs when we improve or increase the usefulness of a commodity by changing its form or shape. Undoubtedly we would all agree that metal in the form of a late-model Mustang is more useful than a heap of iron ore or a few steel ingots. Most of our factories add form utility in producing such items as furniture, toys, and computers.

**Place Utility.** **Place utility** occurs when a good or service has more usefulness in one location than in another. The movement of the good to a more useful location creates place utility. For example, a Texas sports star buying a Cadillac will pay a certain price f.o.b. Detroit. However, as long as the car remains in Detroit, it will be of little value to the buyer in Texas. Consequently, the buyer will pay an additional sum of money to have the car transported to Texas.

**Time Utility.** **Time utility** occurs when a commodity or service is more useful at one time than at another. Let us say that you are offered a position as the southern California representative for a Midwestern firm. In addition to the education and the ability to do the job, assume that you must provide your own car to call on company customers. If you do not have a car, you might ask your prospective employer to wait a few years until you can save enough money to buy a car. You would probably be told, however, that the position must be filled immediately. In this situation the car is more useful to you now than later, for without it this job opportunity may be lost. Rather than let the opportunity pass, you may go to an automobile dealer, select a car, and pay for it on the installment plan.

The person, company, or financial institution lending you the money relinquishes that money for a period of time to make a product available to you now. The lender is entitled to some remuneration, usually in the form of interest, for the service in creating this time utility. Production in the form of time utility is a big business in our economy. In 1986, about \$560 billion in installment and other consumer credit loans was outstanding, and family home mortgages were approximately \$1.5 trillion. Indeed, time utility is a potent force in our economy.

**Possession Utility.** **Possession utility** results when the ownership of a good or service is transferred from one person to another. For example, a set of carpenter tools on display in a hardware store is of no value to the carpenter who may need them as long as they remain in that window. If the carpenter obtained possession of the tools, however, they could be useful to the carpenter in earning a living. In negotiating a transfer of the tools from the hands of the original owner or producer to the carpenter,

a salesperson creates possession utility. That is true also of the transfer of the ownership of homes, food, clothing, and other items.

## Economics and Distribution

At first glance many individuals may regard this part of our definition as referring to the physical distribution of goods and services from the producer to the consumer, or what is called *marketing distribution*. If that were the case, however, our definition would be redundant since we have indicated that such distribution is part of production because it creates place, time, and possession utilities. But in our definition of **distribution** we are referring to the allocation of the total product among the factors of production. In monetary terms it can be considered as the distribution of money incomes among the owners of the factors of production.

**Factors of Production.** Before a person or business can engage in the production of goods or services, certain prerequisites or corequisites are necessary. These are (1) labor, (2) land, (3) capital, and (4) entrepreneurship, known as the **factors of production**.

**Labor.** **Labor** refers to the time and effort of human beings involved in the productive process. Labor includes both physical and mental application by individuals and groups—both executives and blue-collar workers. It includes the application of human effort for the production of services as well as the production of goods.

**Land.** As used in economics, the term **land** is much broader than the concept of real estate. It includes not only real estate but all the resources of the land, sea, and air. Such items as coal, oil, lumber, chemicals, water, coral, air, and rain are illustrations of this factor of production.

**Capital.** Goods produced may be consumed directly or used in production. **Capital** includes those goods used to produce other goods. Capital also includes goods that produce services. Such items as blast furnaces, punch presses, buildings, bulldozers, computers, trucks, airplanes, and the like are considered capital. In a narrower sense of the term, capital is often applied to money. From an economic point of view this is correct insofar as money can be used to purchase the equipment, material, and labor necessary to produce other goods.

**Entrepreneurship.** **Entrepreneurship** is derived from a French word meaning “an undertaking.” The **entrepreneur** organizes the business enterprise and assumes the risk. This function is distinguished from that of the laborer, the landlord, and the capitalist. It is the entrepreneur, or enterpriser, who combines the other factors of production—land, labor, and capital—to produce the final product.

Today a renewed emphasis is being placed on the concept of the entrepreneur. Many universities and state industrial development departments

are teaching special courses and conducting workshops in entrepreneurship. Many individuals have taken on the role of entrepreneur. Both in the United States and abroad, particularly in developing countries, there is a growing need for the promotion of business and economic development by entrepreneurs who can put all the factors together.

**The Problem of Distribution.** In a self-sufficing barter economy, individuals produced for their own needs, and if there were any excess, they may have traded with their neighbors. Under this type of system, individuals generally used their own labor or that of their family, their own land, their own tools, and their own entrepreneurship to produce the goods they needed. Assuming the right of private property existed, there was no question about the ownership of the goods they produced or about the share to which they were entitled.

In our modern, complex economy, the problem is more involved. An individual who wants to produce must still use the basic factors of production. In bringing together the factors of production, however, the entrepreneur may use the labor of one person, the land of another, and the capital of a third. By combining their activities, a product is produced that has a certain value. Now the big question arises: What will be the share or remuneration of each of the factors for its contribution to the total product? In our economy remuneration for the factors of production—labor, land, capital, and entrepreneurship—is made in the form of wages, rent, interest, and profits, respectively, as shown in Figure 1-1. This is called the functional distribution of income.

The problem of distribution has plagued economists for nearly two centuries, and we still do not have a simple solution. In earlier days, most economists and textbooks devoted a considerable amount of time to this problem. Consequently, we have had a whole parade of theories about functional distribution.

**Theories of Distribution.** The theory of distribution is not a single integrated theory. Instead it is made up of numerous theories endeavoring to explain how the remuneration to one or more of the factors is determined.

Theories abound in the determination of wages, rent, interest, and profit. All add to the complexity of the issue. If one studies any economic system other than capitalism, one will find that the theory of distribution differs. Thus, in a way, the theory is a product of our economic environment.

**Allocation to Factors.** Although none of the theories can adequately explain how the remuneration to a particular factor of production is determined, each adds a modicum of understanding to the method or process of its determination. For example, profits may arise according to any one of several theories or a combination of several of the theories. Furthermore, in determining the remuneration to any one factor, the other factors cannot