

MACRO ECONOMIC PROBLEMS and POLICIES

Practice in Thinking

FELS

BUCKLES

JOHNSON

Fourth Edition

MACROECONOMIC PROBLEMS & POLICIES:

Practice in Thinking

FOURTH EDITION

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FOREWORD

MACRO • MACRO • MACRO • MACRO • MACRO • MACRO • MACRO • MACRO • MACRO • MACRO • MACRO • MACRO

There are three main objectives to the elementary course in economics: to master economic principles, to acquire skill in applying the principles to reality, and to learn to analyze policy issues systematically. The usual textbook and the usual course overemphasize the first, underemphasize the other two. Even the books of readings and the cases now available are usually designed more to illustrate how economists apply theory than to train students in doing it themselves. But the long-run purpose of a liberal education requires emphasizing skill in applications as much as knowledge of abstractions. In principle, a person with a liberal education might take a lively interest for the rest of his life in economic theory rather than policy, but in practice a person with one semester or one year of economics will promptly forget the theory unless he has developed an interest in applying it to what he reads in newspapers and magazines. For purposes of a liberal education, theory and application must go hand in hand.

The cases in this book are designed to train students to apply economic principles to the kind of articles they will encounter throughout their lives in newspapers and magazines. The cases also provide training in how to analyze economic policy issues. Frequently there are no right or wrong answers to the questions asked; students are expected to think for themselves. This is the reason for the subtitle, *Practice in Thinking*.

For the convenience of instructors who teach macro in one semester of the introductory course, micro in another, the *Casebook* has been split. Besides the volume containing both micro and macro cases, there are two smaller books, one with the micro cases only, the other with the macro cases only.

The cases are intended primarily for class discussion but can be used in other ways as well, e.g., as the basis for writing papers. To apply economic principles to the cases, the student must first learn the principles themselves, mainly by studying a textbook. The standard textbooks neglect certain micro principles and concepts essential for applications. In Part One of both the full *Casebook* and the separate micro volume we have provided an explanation of allocative efficiency and its relation to income distribution.

Standard textbooks also neglect the important subject of value judgments and their relation to economic policy. We have written an essay, "Values, Goals, and Economic Policy," on this subject. It is included in the macro *Casebook* as well as the full *Casebook* but is omitted from the micro volume for reasons of space.

We have also provided a glossary. It serves three purposes: ready reference, review, and clarification. Some of the cases have checklists of the principles and concepts to be used in analyzing them. When the student needs to refresh his memory, he can refer to the glossary. That is its main purpose. Because the glossary is limited to important ideas, the student can also use it for review purposes at the end of the course. It is in fact a summary of the cognitive knowledge we hope students will acquire. The glossary also clarifies terminology. Different economists often use a term in different ways or use different terms for the same idea. In the absence of standardization, the glossary is a guide to how terms are used in this *Casebook*.

In revising the *Casebook*, we have kept the best cases from the previous editions and replaced others with new ones. We have increased the number of microeconomic and international economics cases and have added a case that is both macro and micro.

We are grateful to the many instructors who sent in their comments and evaluations. We wish to acknowledge the help of Kate Langston and Deena Schmidt in preparing the manuscript. Finally we wish to repeat our thanks to Ewing P. Shahan, John J. Siegfried, and Robert G. Uhler for their help and to the Joint Council on Economic Education and the Sloan Foundation for support of the experimental course in elementary economics which led to this *Casebook*.

RENDIGS FELS
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MACRO 1

PROBLEM CASES ON MACROECONOMICS

Instructions for Part One

Here is an example of a problem case in macroeconomics. The following dispatch from the Associated Press appeared in newspapers on December 12, 1977.¹

Inflation 'Drag On Growth'

NEW YORK (AP)—Inflation and the fear of inflation will pull down real economic growth in the industrialized world to a sluggish 4 percent next year, a private survey organization predicted Sunday.

The Conference Board, which surveys business conditions and trends, estimated that Japan could expect the highest real growth rate, about 6 percent.

Italy and the United Kingdom were expected to have the lowest growth rates, with Italy's about 3 percent and the United Kingdom's about 4 percent.

For the United States, growth of 4 to 4.5 percent was forecast, but prices could rise by 7 percent.

It said that major barriers to growth next year were modest consumer spending—reflecting both high unemployment and high inflation—and a fear of inflation that makes governments shy of policies that would expand their economies.

It also said that many nations were using only 70 to 80 percent of industrial capacity, giving little incentive to increase capital spending, and that most countries were having trouble increasing exports.

¹ Copyright 1977 by Associated Press. Reproduced by permission.

Think through the answers to these questions before reading on.

QUESTIONS

1. What economic concepts and principles are needed to analyze the article?
2. By what percent was the GNP of the United States in current dollars expected to increase in the next year? Explain.
3. (a) How can inflation slow the rate of economic growth? The article suggests two ways. What are they?
(b) Which of the two explanations seems more convincing to you? Why?

* * * * *

Here are some sample answers. You and your instructor may not fully agree with them. If not, so much the better.

1. Inflation, economic growth, fiscal and monetary policies, the marginal propensity to consume, the distinction between current and constant dollars, and GNP.
2. Eleven to 11.5 percent. The growth in GNP in current dollars is approximately equal to the sum of the growth in constant dollars (4 to 4.5 percent) and the increase in prices (7 percent).
3. (a) The article suggests two ways in which inflation might slow economic growth: "modest consumer spending—reflecting . . . high inflation" and "a fear of inflation that makes governments shy of policies that would expand their economies." The latter is readily understood. Governments concerned with high rates of inflation may use restrictive fiscal and monetary policies to reduce spending. The side effect is to reduce the rate of real economic growth.

The other suggested way that inflation might slow economic growth is less obvious. Other things remaining the same, including personal incomes, inflation reduces the real incomes of consumers. Since the marginal propensity to consume out of real income is a positive fraction, lower real incomes means less spending on consumer goods, which in turn reduces the rate of growth of output.

3. (b) The fear of contributing to further inflation and subsequent restrictive policies is the stronger argument. While it is true that, other things remaining the same, the higher the rate of inflation the lower are real incomes, it is not legitimate in this context to include personal incomes in the other things remaining the same, since one of the effects of inflation is to raise personal incomes.

Part One aims at alerting students of the need to be wary in reading newspapers and to use their knowledge of macroeconomics to detect errors, to get deeper insight into the information provided by popular sources, and to tell whether policy proposals are likely to achieve the goals intended by their proponents.

MACRO

CASE 1

Pollution, Inflation, And Growth

Text from United Press International

WASHINGTON (UPI)—The government estimated yesterday air and water cleanup through 1976 will cost industry \$31.6 billion, eliminate 50,000 to 125,000 jobs, spur inflation, and dampen economic growth.

But the report, issued by the White House Office of Environmental Quality (OEQ), concluded the country will be better off despite the costs. It said the economy will keep growing, although a bit slower, and "no industries will be severely impacted" although 200 to 300 plants will close.

The \$350,000 study was sponsored by OEQ, the Environmental Protection Agency (EPA) and the Commerce Department. Its sponsors emphasized that researchers focused on industrial costs resulting from federal antipollution regulations, and did not consider the benefits of cleaner air and water.

Not cranked into the economic analysis, for example, was EPA's estimate that air pollution causes \$16 billion damage a year, not counting non-economic losses such as shorter human lives and uglier cities.

The researchers studied 14 industries in detail, then applied some of the data to the manufacturing industry as a whole. The study did not cover government antipollution spending, nor costs for mining, farming, and cars.

IT DID, however, consider economic benefits such as new plants and new jobs in industries manufacturing pol-

lution control equipment. The report concluded these pluses would not offset the economic minuses caused by mandatory antipollution spending.

"Prices rise as a result of the cost-push impact of pollution control costs," the report said. ". . . The effect of rising prices, which tends to slow the growth of demand in the economy, outweighs the stimulating impact of investments in pollution control facilities."

The report estimated prices would increase up to 2 percent a year in some industries, and said profits would decline in industries unable to pass on their antipollution costs. Of 12,000 plants in the fourteen closely studied industries, it estimated that by 1976 "200 to 300 will be forced to close because of pollution abatement requirements."

IT SAID, however, most such plants are marginal and "the vast majority" would close a few years later anyway.

The report estimated job losses through 1976 at 50,000 to 125,000, equal to between 1 percent and 4 percent of total employment in the fourteen industries or .5 percent of the national work force.

It said plant closings would badly hurt 50 to 150 communities, mostly one-plant towns hit by a shutdown.

The fourteen industries included in the survey were autos, baking, ce-

ment, electrical generating, canning and freezing, iron foundries, leather tanning, steel, aluminum, copper, lead, zinc, petroleum refining, and pulp and paper.

Checklist of Economic Concepts and Principles in Macro Case 1, "Pollution, Inflation, and Growth."

Allocative efficiency

Aggregate demand

GNP

Income distribution

Investment

Macroeconomics

Microeconomics

Multiplier

Other things remaining the same

Social benefit, private benefit, external benefit

Social costs, private costs, external costs

Supply and demand, law of

— QUESTIONS —

1. The first paragraph of the UPI dispatch reproduced in this case says that the pollution cleanup which is expected to cost industry \$31.6 billion through 1976 will "eliminate 50,000 to 125,000 jobs." Does this mean that total employment in the United States in 1976
 - (a) will be 50,000 to 125,000 lower than it was on the date of the news article?
 - (b) will be 50,000 to 125,000 lower in 1976 than if the pollution cleanup were not undertaken?
 - (c) will be the same but 50,000 to 125,000 individuals will have to seek new jobs?
 - (d) will be none of the above?
 Explain.
2. In the light of your answer to question 1, does the statement about elimination of jobs belong mainly to macroeconomics, mainly to microeconomics, or equally to both?
3. The first paragraph also says that the pollution cleanup will "spur inflation." Do you agree? Why or why not?
4. Do you agree that the pollution cleanup will "dampen economic growth"? Why or why not?
5. What effect will the imposition of federal antipollution regulations have on allocative efficiency?
6. In a competitive industry, the installation of antipollution devices raises the costs of production. What effect will this have on the industry?
7. Manufacturers of antipollution devices (e. g., water treatment equipment, filters, scrubbing towers, precipitators, etc.) should benefit. How will investment in this type of equipment affect the economy in general?
8. How will income distribution be affected by "pollution cleanup"?

MACRO
CASE 2

The Inescapably Central Role of Income Distribution

Text by G. L. Bach and Bent Hansen

The text of this case includes quotations from book reviews by G.L. Bach and Bent Hansen which appeared in the December 1974 and March 1975 issues of the Journal of Economic Literature, pp. 1331 and 79, respectively. Copyright 1974 and 1975, American Economic Association. Reproduced by permission.

In the 1970s the United States—like most other countries with mixed economies—has suffered from a cruel dilemma. Inflation could be stopped only at enormous cost in terms of lost output and unemployment. Full employment and maximum output could be had only at the expense of intolerable inflation. In practice the United States has chosen neither stable prices nor full employment but has put up with a good deal of inflation and a good deal of unemployment.

What is the fundamental cause of the inflation-unemployment dilemma? G. L. Bach finds it in "the political process that makes the use of high-employment policy so difficult, and the inescapably central role of the income distribution issue in stabilization policy today. Our current American mores are that almost everyone should have 'more' every year as a matter of social justice, rather than something to be justified on the economic merits. Congress is increasingly receptive to

pleas to take care of special interests through the political process, when they cannot get their 'just' due in the market. We resolutely refuse to face the central issue that, when there is not enough to go around, somebody's income claims must be shut off if we are to live in a tolerably non-inflationary world. This is the essence of the macroeconomic policy issue in today's world, and we economists will have a difficult time giving useful macroeconomic advice unless we face up to it as central to the problem. Who gets how much of the GNP pie when there are large excess income claims over the total available at stable prices is the political and economic core of the inflation-employment policy issue."

Another insight comes from Bent Hansen: "Cost-inflation does not only, and perhaps not even primarily, arise simply because the recipients of factor income (wages, profits, etc.) try to obtain shares in national income which add up to more than 100 percent, but also, and perhaps more often, arises when income recipients try to preserve their share of national income when faced with a growing public sector. It has been maintained, probably rightly so, that Scandinavian countries should be in this kind of situation with labor leaders happily voting for big expenditure increases and, most responsibly,

agreeing to increased value-added tax rates to take care of the financing—and then going home to their union-fiefs and demanding compensation for cost-of-living increases due to increased indirect taxation. It is even

held that for this reason cost-inflation is the inevitable bed fellow of the welfare state. Be that as it may, the problem here is clearly a fiscal one and one cure, if any, is fiscal: cut down the budget."

— QUESTIONS —

1. Is Bach's account of "the inescapably central role of the income distribution issue in stabilization policy" entirely based on cost-push inflation? Entirely demand-pull? Some of both? If both, which is predominant?
2. Is Hansen's account entirely cost-push? Entirely demand-pull? Some of both? If both, which is predominant?
3. What is the relation between Bach's account and Hansen's? Is one a general account, the other a specific illustration? If so, which is which?
4. "The inflation-unemployment dilemma is political, not economic. Economists know perfectly well how to solve the problem, but none of their solutions is politically realistic." Do you agree or disagree? Explain.

MACRO
CASE 3

Inflation Expected

By John Cunniff, AP Business Analyst

The text of this case is from Associated Press. It appeared in newspapers on January 16, 1978. Reprinted by permission.

NEW YORK (AP) — The notorious pickpocket, cost-push inflation, is expected to be more active in our society during 1978, dipping his sticky fingers every time we open our wallets.

Why we tolerate the scurrilous chap isn't all that clear, but perhaps it's because we think of him as a Robin Hood, redistributing income by taking more from our neighbors than he takes from us.

While this has some basis in fact, the truth is that this profligate rake costs us all in the long run. His first name is aptly applied: he pushes up all prices because he makes it more costly to produce.

That is, the poseur will draw his livelihood from more sources this year than in 1977. Among them:

- A larger federal budget deficit, which means in effect that the country will seek to do more than it is willing to finance. It will overspend, but it will try to make out that it isn't doing so.

The result: The value of the dollar will be diluted. It will buy less. The taxes we didn't levy to pay for that

spending will be lifted from us anyway by the pickpocket.

- The probability of more rapid monetary expansion. An easier money policy makes it easier to spend.

- Higher minimum wage. Conceding the humanitarian motives behind the increase, it nevertheless will put upward pressure on prices. This has been the experience; most likely it will continue to be.

- Higher farm price supports. Again, the matter of justice for the farmer does not detract from the consequence: food prices are likely to be higher in 1978 than in 1977.

- Protectionism. It is growing. U.S. producers are seeking insulation against foreign goods, some of which are suspected of being dumped here at prices below production costs.

This is a thorny issue. Low-priced imports cost the country in lost jobs and production. But balanced against that consequence is the fact that in protecting those jobs we force up consumer prices.

There are many other factors that might sweeten the dole to the merry swindler called inflation, such as the possibility of higher oil prices, or at least our continued dependence on foreign supplies.

— QUESTIONS —

1. What is cost-push inflation?
2. The article suggests several possible sources of cost-push inflation in 1978. What are the sources? Do you agree that these events could cause cost-push inflation?
3. Does a larger federal budget deficit contribute to inflation?
4. Does a more rapid monetary expansion cause inflation?
5. What are the tradeoffs among goals that result with adoption of higher minimum wages, higher price supports for farm products, and protectionism?

MACRO
CASE 4

Carter to Propose \$25 Billion Tax Cut

By Clyde H. Farnsworth

The text of this case appeared in the New York Times on December 21, 1977. Copyright 1977 by the New York Times Company. Reproduced by permission.

WASHINGTON, Dec. 20 — President Carter has decided on a \$25 billion tax reduction and revision package designed to stimulate the economy and check inflation, top Administration sources said today.

The cuts, to become effective next October 1, would be fairly straightforward, with lower rates for both businesses and individuals, the sources said, and are in line with what many in the business community have been recommending.

The proposed reductions, to be sent to Congress next month, are expected to be well received there: Congressional sources forecast more trouble with the "reform" elements of the expected package, even though the most controversial of the proposals considered by the President—the end of special tax breaks for capital gains—has now been shelved indefinitely.

Two-Stage Reduction

The key decisions—made by the President last night and this morning before he signed into law a bill raising taxes to shore up the Social Security

system—include, according to the sources, the following:

- The corporate tax rate is to be reduced in two stages from the present 48 percent to 44 percent. The first three percentage points of the cut would become effective October 1, 1978. On January 1, 1980, there would be the final reduction of one point to 44 percent.

- The present 14 to 70 percent range for individual tax rates would be lowered to 12 to 68 percent. The existing \$750 personal exemption and \$35-a-person credit would be replaced with a personal credit of either \$240 or \$250, with some technicalities still to be worked out. The effect of these changes would be to reduce everyone's taxes; those gaining the most would be in the lower tax brackets.

- To help fight inflation, the President will propose an end to the excise tax on telephone bills, now 5 percent and scheduled to drop to 4 percent next January 1. This would wind up the last of the luxury taxes enacted during World War II. The tax during wartime had been set at 20 percent.

- In an additional effort to check price pressures, Mr. Carter will propose a reduction in the employer contribution to federal unemployment insurance from the current seven-tenths of 1 percent to five-tenths of 1 percent