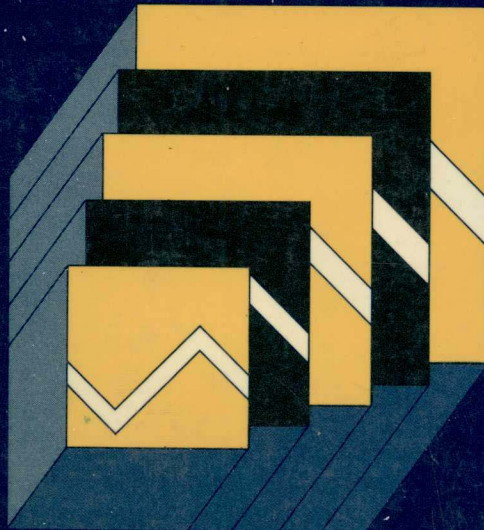


ECONOMICS

Principles and Policy

Second Edition



Harcourt Brace Jovanovich International Edition

William J. Baumol and Alan S. Blinder

ECONOMICS

Principles and Policy

Second Edition

William J. Baumol
New York University
and
Princeton University

Alan S. Blinder
Princeton University



Harcourt Brace Jovanovich, Inc.

New York San Diego Chicago San Francisco Atlanta
London Sydney Toronto

To my three children,
Ellen, Daniel,
and now Sabrina

W.J.B.

For William and Scott,
who supply competition
and demand equity

A.S.B.

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Printed in the United States of America
Library of Congress Catalog Card Number 81-83083
ISBN: 0-15-518835-6

CREDITS AND ACKNOWLEDGMENTS

p. 11: © Rand McNally & Company, R. L. 78-Y-98; p. 12, top: © 1971, General Drafting Co., Inc.; bottom: Gousha; p. 15: The London School of Economics and Political Science; p. 26: U.S. Geological Survey; p. 48: Brown Brothers; p. 54: The Bettmann Archive, Inc.; p. 81: Brown Brothers; p. 98: From *The Wall Street Journal*, permission—Cartoon Features Syndicate; p. 108: Camera Press—PHOTO TRENDS; p. 148: Brown Brothers; p. 173: UPI; p. 216: B.C. by permission of Johnny Hart and Field Enterprises, Inc.; p. 249: Prepared by the Federal Reserve Bank of St. Louis; p. 299: Art adapted from *Economica*, Nov., 1958; p. 435: Krokodil/Sovfoto; p. 461: Reprinted by permission of *The Wall Street Journal*, © Dow Jones and Co., 1981. All rights reserved.; p. 462: Reprinted by permission of *The Wall Street Journal*, © Dow Jones and Co., 1981. All rights reserved.; p. 547: Gropper, William. "The Senate" (1935). Oil on canvas, 25-1 $\frac{1}{8}$ " x 33- $\frac{1}{8}$ ". Collection, The Museum of Modern Art, New York. Gift of A. Conger Goodyear.; p. 562: UPI; p. 574: Culver Pictures, Inc.; p. 607: Opinion Research Corporation; p. 628: The Bettmann Archive, Inc.; p. 664: UPI; p. 671: Art adapted from Walter G. Hoffmann, *Das Wachstums der Deutschen Wirtschaft Seit der Mitte des 19 Jahrhunderts* (Berlin: Springer-Verlag, 1965); p. 688: Photo courtesy of Mobil Oil Corporation; p. 691: Reprinted with permission of American Metal Market/Metalworking News, © 1981, Fairchild Publications, a Division of Capital Cities Media, Inc.; p. 714: Culver Pictures, Inc.; p. 747: Drawing by Ed Fisher; © 1971, The New Yorker Magazine, Inc.; p. 770: The Bettmann Archive, Inc.; p. 784: UPI; p. 792: Organization for Economic Cooperation and Development; p. 794: Organization for Economic Cooperation and Development; p. 802: Sovfoto; p. 809: UPI; p. 811: UPI.

Preface

For decades, the “principles of economics” book has been expected to codify the entire discipline of economics, to blanket the field, to be encyclopedic. In recent years, this has become at once more imperative and more difficult. On the one hand, the explosion of economic knowledge during the last several decades has made it impossible to put all of economics, even at an introductory level, between two covers. On the other hand, it seems that more and more public policy issues either are basically economic in nature or involve important economic considerations. Intelligent citizens can no longer afford to be innocent of economics.

While the Second Edition represents a rather extensive revision of the First Edition, its preparation has been guided by this dilemma, just as the first volume was. We have studiously avoided the encyclopedic approach and abandoned the fiction, so popular among textbook writers, that literally everything is of the utmost importance. Since students are sufficiently intelligent to see through this ruse in any event, we have tried to highlight those important ideas that are likely to be of lasting significance—principles that you will want to remember long after the course is over because they offer insights that are far from obvious, because they are of practical importance, and because they are widely misunderstood by intelligent laymen. A dozen of the most important of these ideas have been selected as “12 Ideas for Beyond the Final Exam,” and are called to your attention when they occur through the use of the book’s logo. 

All modern economics textbooks abound with “real world” examples, but we have tried to go beyond this, to elevate the examples to preeminence. For in our view, the policy issue or everyday economic problem ought to lead the student naturally to the economic principle, not the other way around. For this reason, many chapters start with a real policy issue or a practical problem that may seem puzzling or paradoxical to noneconomists, and then proceed to describe the economic analysis required to remove the mystery. In doing this, we have tried to utilize technical jargon and diagrams only where there is a clear need, never for their own sake.

Still, economics is a somewhat technical subject and, except for a few rather light chapters, this is a book for the desk, not for the bed. We have, however, made strenuous efforts to simplify the technical level of the discussion as much as we could without sacrificing content. Fortunately, almost every important

idea in economics can be explained in plain English, and this, in general, is how we have tried to explain them. Yet, even while reducing the technical difficulty of the book, we have incorporated some elements of economic analysis that have traditionally been left out of introductory books but that are really too important to omit. Foremost among these is our extensive treatment of prices and inflation in Part Two. Introductory (and even intermediate) texts typically devote many chapters to a hypothetical economy in which prices never rise. Here, from the very beginning, we analyze the world as it really is, with prices all too easily driven upward.

Changes from the First Edition

While the philosophy behind the book is unchanged from the First Edition, the implementation of this philosophy is quite different. Most important, the microeconomic portions of the book (Parts Three through Six) have been extensively reorganized, rewritten, and restructured about a central theme that we believe deals with the most significant lessons to be learned in an introductory economics course: what a market system does well, and what it does poorly. Thus, in Part Three we carefully examine the virtues of an idealized system of markets. This helps to explain how the market economy has been able to produce its remarkable accomplishments in terms of efficiency and service to consumers. Then in Parts Four (Big Business and Market Power), Five (Market Failure), and Six (Distribution of Income), we explain some of the things that can go wrong.

In addition to these organizational changes, the following chapters are either all new or have been thoroughly revised since the First Edition: Chapters 3 and 4 (introductory materials), Chapters 20–23 (on the theory of the firm and perfect competition), Chapters 25 and 26 (on monopoly, monopolistic competition, and oligopoly), Chapter 29 (on market failure), Chapters 32 and 33 (on factor markets), and Chapter 36 (on the economics of energy).

Specifically, Chapter 3 now includes expanded discussions of traditional topics such as exchange, specialization, division of labor, and economic efficiency; and a discussion of the role of markets has been added. The new central theme is introduced in Chapter 3 and carries over to Chapter 4's introduction to supply and demand, which features a much more detailed and systematic treatment of shifts in supply and demand curves than did the First Edition.

Chapters 18 and 19, on consumer theory, appear in reverse order from their presentation in the First Edition and have been rewritten in accord with several valuable suggestions from users. For example, there is a much more extensive discussion of elasticity of demand. Chapters 20 and 21, on cost minimization and profit maximization, also have been reversed in order and entirely rewritten. In these chapters especially, and throughout the micro sections, there are longer explanations, more numerical examples, and more graphs than in the First Edition. Also, the discussions have been revised to proceed more deliberately and systematically through the important microeconomic principles. For example, cost curves are explicitly derived from the production function in Chapter 20.

The chapters on market structure (Chapters 22, 25, 26) are also completely reorganized and rewritten. The perfectly competitive firm and the perfectly competitive industry are now treated in the same chapter, and interactions between developments at the level of the firm and developments at the level of the industry are stressed. There is also more material on agriculture. Monopoly

occupies a separate chapter; and the discussion of monopolistic competition and oligopoly are greatly expanded. Chapters 32 and 33, on factor pricing, now include a number of new topics, such as critiques of marginal productivity theory, human capital theory, and dual labor markets.

Overall, the macroeconomic section (Part Two) is similar to that of the First Edition, but has been brought up to date to include (a) the most current data available; (b) institutional changes since publication of the First Edition—for example, those that have affected the financial system and the definitions of money; and (c) the economic history of the years 1979–1981—for example, the second oil shock and the Reagan program. In particular, an extended discussion of “supply-side” economics and related matters appears in Chapters 9, 11, and 17. The national income accounting materials (which include 1981 data) no longer constitute a separate chapter; instead, some have been incorporated into the text (especially in Chapters 5 and 7) while most now appear in the appendix to Chapter 7. Several algebraic appendixes have been added (specifically, to Chapters 8, 10, and 11) for courses in which income determination theory is taught with the help of some simple algebra.

Chapter 16, on the trade-off between inflation and unemployment, has been extensively revised. In the First Edition, we treated the *static* trade-off between the *price level* and the *level* of real GNP. In this edition, we apply the same analysis to the *dynamic* trade-off between the *inflation rate* and the *unemployment rate* (which, in a growing economy, is related to the growth rate of real GNP). This alteration permits a much smoother transition from the theoretical model in the text to empirical Phillips curves. The expectational Phillips curve and rational expectations, which are treated only implicitly in the First Edition (that is, the concepts were present, but the terms were not), are now treated explicitly. There is a new chapter, “Coping with Inflation,” which pulls together materials from several chapters of the First Edition and adds new material, especially on inflation as a long-run problem and on how productivity growth relates to inflation.

In keeping with our emphasis on current developments, Part Seven now contains an entirely new chapter on energy and natural resources, which replaces the First Edition’s chapter on cities. Other chapters in Part Seven have been brought up to date, but are otherwise similar to those of the First Edition.

Studying Principles of Economics

Most courses will begin with Part One, where we have touched most of the traditional bases while keeping the introductory materials briefer than in most texts. Courses concentrating on macroeconomic theory and policy will proceed next to Part Two, while courses specializing in microeconomics will skip to Part Three. Either sort of course may make use of some of the chapters in Part Seven.

Whatever the nature of your course, we would like to offer one suggestion. Unlike some of the other courses you may be taking, principles of economics is cumulative—each week’s lesson builds on what you have learned before. You will save yourself a lot of frustration (and also a lot of work) if you keep up on a week to week basis. To help you do this, there is a chapter summary, a list of important terms and concepts, and a selection of discussion questions to help you review at the end of each chapter. In addition to these aids, many students will find the *Study Guide*, designed specifically to accompany this text by Professor Craig Swan, helpful as a self-testing and diagnostic device. When you encounter difficulties in the *Study Guide*, you will know which sections of the text you need to review.

Note to the Instructor

The ordering of chapters in the book is based on courses which treat macroeconomics before microeconomics. All of the macroeconomic analysis is found in Part Two. The core micro materials occupy Parts Three through Six, in an order chosen to emphasize the central theme: the working of markets. Part Three describes the theory of the consumer and the theory of the firm and ends with a discussion of perfect competition and the invisible hand at its best. Part Four deals with imperfect competition and policy. Part Five generalizes the discussion of imperfections of the market mechanism. Part Six deals with the theory of distribution. The remaining chapters (Part Seven) contain an assortment of miscellaneous topics that you will use or omit at your discretion. There seems to us no obvious "order" in which to treat these chapters.

What follows is a set of suggested course outlines predicated on the assumptions that (a) a one-semester course will be able to cover about half the book, (b) a one-quarter course will be able to cover about one-third of the book, and (c) the macro course precedes the micro course.

OUTLINE FOR A ONE-SEMESTER COURSE EMPHASIZING MACROECONOMICS

Chapter Number	Title
1	What Is Economics?
2	The Use and Misuse of Graphs
3	Scarcity and Choice: <i>The</i> Economic Problem
4	Supply and Demand: An Initial Look
5	Macroeconomics and Microeconomics
6	Unemployment and Inflation: The Twin Evils of Macroeconomics
7	Aggregate Demand and the Powerful Consumer
8	Demand-Side Equilibrium: Unemployment <i>or</i> Inflation?
9	Supply-Side Equilibrium: Unemployment <i>and</i> Inflation?
10	Changes on the Demand Side: Multiplier Analysis
11	Managing Aggregate Demand Through Fiscal Policy
12	Banking and the Creation of Money
13	Central Banking and Monetary Policy
14	Money, the National Economy, and the National Debt
15	The Keynesian–Monetarist Debate and Forecasting
16	The Trade-Off Between Inflation and Unemployment
17	Coping with Inflation
35	Economic Growth: Causes, Virtues, and Vices
37	International Trade and Comparative Advantage
38	The International Monetary System: Order or Disorder?
39	Problems of the Less Developed Countries (optional)

OUTLINE FOR A ONE-SEMESTER COURSE EMPHASIZING MICROECONOMICS

Chapter Number	Title
1	What Is Economics?
2	The Use and Misuse of Graphs

Note to the Instructor

The ordering of chapters in the book is based on courses which treat macroeconomics before microeconomics. All of the macroeconomic analysis is found in Part Two. The core micro materials occupy Parts Three through Six, in an order chosen to emphasize the central theme: the working of markets. Part Three describes the theory of the consumer and the theory of the firm and ends with a discussion of perfect competition and the invisible hand at its best. Part Four deals with imperfect competition and policy. Part Five generalizes the discussion of imperfections of the market mechanism. Part Six deals with the theory of distribution. The remaining chapters (Part Seven) contain an assortment of miscellaneous topics that you will use or omit at your discretion. There seems to us no obvious “order” in which to treat these chapters.

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14	Money, the National Economy, and the National Debt
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16	The Trade-Off Between Inflation and Unemployment
17	Coping with Inflation
35	Economic Growth: Causes, Virtues, and Vices
37	International Trade and Comparative Advantage
38	The International Monetary System: Order or Disorder?
39	Problems of the Less Developed Countries (optional)

OUTLINE FOR A ONE-SEMESTER COURSE EMPHASIZING MICROECONOMICS

Chapter Number	Title
1	What Is Economics?
2	The Use and Misuse of Graphs

3	Scarcity and Choice: <i>The Economic Problem</i>
4	Supply and Demand: An Initial Look
18	The Common Sense of Consumer Choice
19	The Nature of Consumer Demand
20	The Common Sense of Business Decisions: Inputs and Costs
21	The Common Sense of Business Decisions: Outputs and Prices
22	The Firm in the Marketplace: Perfect Competition
23	The Price System and the Case for Laissez Faire
24	Firms in Reality: The Corporation and the Stock Market
25	Pure Monopoly and the Market Mechanism
26	Between Competition and Monopoly
27	Limiting Market Power: Regulation of Industry
28	Limiting Market Power: Antitrust Policy
29	Shortcomings of the Market Mechanism and Government Attempts to Remedy Them
30	Taxation, Government Spending, and Resource Allocation
32	Pricing the Factors of Production: Interest, Rent, and Profits
33	The Labor Market and Wages

Plus Any Two of the Following:

31	The Economics of Environmental Protection
34	Poverty, Inequality, and Discrimination
36	The Economics of Energy and Natural Resources
40	Marxian Economics
41	Comparative Economic Systems: What Are the Choices?
42	Dissenting Opinions: Conservative, Moderate, and Radical

OUTLINE FOR A ONE-SEMESTER COURSE COVERING BOTH MACRO AND MICRO

Chapter Number	Title
1	What Is Economics?
2	The Use and Misuse of Graphs (optional)
3	Scarcity and Choice: <i>The Economic Problem</i>
4	Supply and Demand: An Initial Look
5	Macroeconomics and Microeconomics
7	Aggregate Demand and the Powerful Consumer
8	Demand-Side Equilibrium: Unemployment or Inflation?
9	Supply-Side Equilibrium: Unemployment <i>and</i> Inflation?
10	Changes on the Demand Side: Multiplier Analysis
11	Managing Aggregate Demand Through Fiscal Policy
12	Banking and the Creation of Money
13	Central Banking and Monetary Policy
14	Money, the National Economy, and the National Debt
19	The Nature of Consumer Demand

20	The Common Sense of Business Decisions: Inputs and Costs
21	The Common Sense of Business Decisions: Outputs and Prices
22	The Firm in the Marketplace: Perfect Competition
23	The Price System and the Case for Laissez Faire
25	Pure Monopoly and the Market Mechanism
26	Between Competition and Monopoly
29	Shortcomings of the Market Mechanism and Government Attempts to Remedy Them
32	Pricing the Factors of Production: Interest, Rent, and Profits
33	The Labor Market and Wages
41	Comparative Economic Systems: What Are the Choices?

OUTLINE FOR A ONE-QUARTER COURSE IN MACROECONOMICS

Chapter Number	Title
1	What Is Economics?
2	The Use and Misuse of Graphs
4	Supply and Demand: An Initial Look
5	Macroeconomics and Microeconomics
6	Unemployment and Inflation: The Twin Evils of Macroeconomics
7	Aggregate Demand and the Powerful Consumer
8	Demand-Side Equilibrium: Unemployment or Inflation?
9	Supply-Side Equilibrium: Unemployment <i>and</i> Inflation?
10	Changes on the Demand Side: Multiplier Analysis
11	Managing Aggregate Demand Through Fiscal Policy
12	Banking and the Creation of Money
13	Central Banking and Monetary Policy
14	Money, the National Economy, and the National Debt
15	The Keynesian–Monetarist Debate and Forecasting
16	The Trade-Off Between Inflation and Unemployment

OUTLINE FOR A ONE-QUARTER COURSE IN MICROECONOMICS

Chapter Number	Title
3	Scarcity and Choice: <i>The</i> Economic Problem
4	Supply and Demand: An Initial Look
18	The Common Sense of Consumer Choice
19	The Nature of Consumer Demand
20	The Common Sense of Business Decisions: Inputs and Costs
21	The Common Sense of Business Decisions: Outputs and Prices
22	The Firm in the Marketplace: Perfect Competition
23	The Price System and the Case for Laissez Faire
24	Firms in Reality: The Corporation and the Stock Market
25	Pure Monopoly and the Market Mechanism
26	Between Competition and Monopoly

29	Shortcomings of the Market Mechanism and Government Attempts to Remedy Them
30	Taxation, Government Spending, and Resource Allocation
32	Pricing the Factors of Production: Interest, Rent, and Profits
33	The Labor Market and Wages

OUTLINE FOR A ONE-QUARTER COURSE ON APPLICATIONS OF BOTH MACRO AND MICRO

Chapter Number	Title
6	Unemployment and Inflation: The Twin Evils of Macroeconomics
17	Coping with Inflation
27	Limiting Market Power: Regulation of Industry
28	Limiting Market Power: Antitrust Policy
31	The Economics of Environmental Protection
34	Poverty, Inequality, and Discrimination
35	Economic Growth: Causes, Virtues, and Vices
36	The Economics of Energy and Natural Resources
37	International Trade and Comparative Advantage
38	The International Monetary System: Order or Disorder?
39	Problems of the Less Developed Countries
40	Marxian Economics
41	Comparative Economic Systems: What Are the Choices?

With Thanks

Finally, and with great pleasure, we turn to the customary acknowledgments of indebtedness. Ours have been accumulating now through two editions. In these days of specialization, not even a pair of authors can master every subject that an introductory text must cover. Our friends and colleagues Charles Berry, William Branson, Lester Chandler, Stephen Goldfeld, Claudia Goldin, Ronald Grieson, Daniel Hamermesh, Peter Kenen, Arthur Lewis, Burton Malkiel, Edwin Mills, Harvey Rosen, and Laura Tyson have all given generously of their knowledge in particular areas. We have learned much from them, and only wish we had learned more.

Many economists at other colleges and universities, including James Actman of Indiana University, Paul Barkley of Washington State University, George Carter of the University of Southern Mississippi, Tom Cate of Northern Kentucky University, David Denslow of the University of Florida, John Fitts of Carnegie-Mellon University, William Freund of the New York Stock Exchange, Malcolm Getz of Vanderbilt University, Otis Gilley of the University of Texas at Austin, Thomas Holmstrom of Northern Michigan University, Bruce Kaufman of Georgia State University, Ercan Kumcu of Boston College, Patrick Lewis of Otterbein College, Henry McCarl of the University of Alabama at Birmingham, Robert Michaels of California State University at Fullerton, John Powelson of the University of Colorado, John Raisian of the University of Houston, Harry Rosen of the U.S. Air Force Academy, Augustus Shackelford of El Camino College, Paul Sommers of the University of California at San Diego, Charles Staley of the State University of New York at Stony Brook, Lorie Tarshis of the Ontario Economic Council, Robert Thomas of Iowa State University, William

Thweatt of Vanderbilt University, and Bernard Udis of the University of Colorado offered useful suggestions for improvements, many of which we have incorporated into the Second Edition. We thank them all, and also thank the more than 130 economists who responded to our questionnaire. Their responses were invaluable in planning this revision.

Our sanity and survival during the preparation of the Second Edition were assured by the intelligence, ability, and pleasantness of our secretaries, Sue Anne Batey Blackman, Phyllis Durepos, Mary Mateja, and Stephanie Sigall, who did so many things and did them all so well.

And finally there are our wives, Hilda Baumol and Madeline Blinder, who have now participated in this project for six years. Their patience, good judgment, and love have made everything go more smoothly than we had any right to expect. We salute them.

William J. Baumol
Alan S. Blinder

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