



Economics

Second Edition

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Economics

SECOND EDITION

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Preface

In the second edition of our introduction to economics, we again pursue two goals: (1) to build a solid foundation in basic and modern economic theory; and (2) to connect theory with policy and issues in today's world. Our approach stresses the interrelationship of these goals. In each chapter we rely on applications to test theoretical insights, and we rely on theory to provide the context for understanding real-world events. We think this is the best way to prepare students to appreciate the power of economic thinking, to see the vital connection between the logic of economics and the issues confronting them on television, in newspapers, in the voting booth, and in their careers.

To build a solid foundation in theory, we present micro- and macroeconomics step by step, illustrating and reinforcing key concepts at every opportunity. We focus patiently on critical concepts such as supply and demand to make sure students are secure in the basics. We also move strongly into contemporary theories, including those relating to transactions costs, cartels, the firm, public choice, aggregate demand/aggregate supply analysis, modern monetarism, rational expectations, and the impact of federal deficits and debt. Although the range and diversity of topics is wide, we have tried not to be encyclopedic. Students gain little from exposure to a smattering of topics strung together without organizing force. We have tried instead to integrate modern perspectives into the book by building upon the fundamentals set forth carefully and consistently throughout.

To connect theory with the world around us, we have woven in hundreds of applications through the book, ranging from the effects of the federal deficit on inflation to the effects of price controls in competitive markets. The diversity of these applications demonstrates the versatility of economic reasoning. (We have a bit more to say about applications under "Special Features" below.)

Since our approach stresses the relationship between theory and real-world issues, the technical presentations in this book are concise and straightforward. We rely heavily on examples to illustrate abstract theory. We describe graphs and graphical relationships in patient detail. And we use an abundance of visual aids to motivate and clarify.

In areas in which disagreements over economic theory have arisen—and contemporary economics has its share of disputes—we seek to give all views a fair and proper hearing. Although this equal-time rule is largely unnecessary in the more settled areas of microeconomics, it is invoked fairly often in the macroeconomic theory and policy sections of the book.

In sum, we feel that the approach of *Economics, Second Edition*, reflects our sense that students too often merely receive the facts and theories of economics in an introductory textbook and too often grow uncomfortable with its abstractness. We want our readers to discover the intuitive appeal of economics, and to share our enthusiasm for a discipline rich in insight. Both students' and instructors' experience with the first edition has convinced us of the usefulness of this approach in learning introductory economics.

New to the *Second Edition*

The second edition of *Economics*, written to reflect new interests in economic and social policy, incorporates far more than cosmetic changes and additions. Major new material includes chapter-length discussions of the Tax Reform Act of 1986 at both the microeconomic (Chapter 19) and macroeconomic (Chapter 33, a new chapter) levels. In addition to macroeconomic issues relating to taxation, Chapter 33 emphasizes the important problems of huge federal deficits and growing debt, along with their implications for fiscal policy and the macroeconomy. A better integration of money and macro theory is provided in the brief introduction to money now given in Chapter 23.

There is also additional material on the institutions of fiscal policy. For example, the roles of the Office of Management and the Budget and of the Congressional Budget Office, along with the entire budget process, are outlined in our "introduction to macro policy" in Chapter 31. There is also more emphasis on current macroeconomic policy and events, such as the Gramm-Rudman-Hollings proposal to balance the budget and the absence of a recent business cycle.

Dozens of smaller additions have been made both in the text and in special features to help the student understand the relevance of modern economic theory and contemporary policy concerns. On the micro side, for example, waiting-time costs (transactions costs) are introduced in Chapter 1; problems of protectionism are placed up front in Chapter 2; rent controls and their effects are illustrated in Chapter 4; new illustrations of monopoly price discrimination, such as brand name counterfeiting and in- and out-of-state tuition differentials, are provided in Chapter 10; the NCAA cartel is used to illustrate the monopsony problem in Chapter 13; the role of the entrepreneur is given new emphasis in Chapter 15; and new illustrations of market failure and proposed solutions are discussed in Chapter 18. Of special significance, we offer several new applications that illustrate how modern economic tools can shed light on important contemporary social problems. In Chapter 12, for example, the economic and social problems of immigration and immigration reform (Simpson-Mazolli) are related to labor supply.

On the macro side, our basic organization is still macro theory (Part V) before monetary theory (Part VI), but the two are more integrated in this edition. The emphasis on building aggregate demand and aggregate supply is retained, but as suggested above, new stress is placed on recent policy discussions, macroeconomic policy institutions, and the problem of taxation, deficits, and debt. A sample of changes includes an illustration of the life cycle profile of consumption (Chapter 23); the elimination of unnecessary and confusing details of the accelerator model (Chapter 24); an emphasis on deposit creation in all financial institutions (not simply commercial banks) and an analysis of some causes of bank and thrift institution failure (Chapter 28); and a discussion of the effects of over- and under-anticipated inflation (Chapter 32).

In Chapter 36, the discussion of comparative advantage has been revamped for clarity. The "new protectionism," the so-called voluntary export restraints negotiated by President Reagan, is also discussed in this chapter, accompanied by a graphical analysis of the equivalence of tariffs and quotas. Chapter 37, on international finance, has been completely rewritten for clarity and includes a simplified discussion of exchange rates that is easier for students to understand. Also in Chapter 37, the problem of trade deficits is now related to the value of the dollar. Among new material in Chapter 38

are an analysis of market developments in China and a discussion of Gorbachev's reforms (*Glasnost*) in the Soviet Union.

As this sampling indicates, the changes made in this second edition have, we believe, furthered our original goal of formulating a clear introduction to basic theory with relevant and interesting applications to economic and social problems.

Special Features

- Many of the text's applications are set off in "Economics in Action" boxes that appear at the ends of chapters. Some of the topics explored are "The U.S. Farm Problem," "The Economics of Law Firms," "All That Glitters: The De Beers Diamond Cartel," "Is Urban Mass Transit Worth the Cost?," "Should Congress Be Forced to Balance the Budget?," "When a Rose Is Not a Rose: Shifting Comparative Advantage in the Flower Industry," and "The Economics of Information: Searching for the Best Deal."
- Within each chapter we have set off brief, interesting perspectives on theory and institutions in "Focus" boxes. Topics include "Corporate Takeovers and 'Greenmail,'" "Palace Ruins, Key Money, and 'Togetherness': Price Controls in Lisbon," "Money and Computers: Banking at Home," "The Winners and Losers from Unexpected Inflation," and "The Soviet Underground Economy."
- A special historical feature titled "Point-Counterpoint" once again concludes each part of the book. Here we offer side-by-side biographies of some of the most important thinkers in economics and compare and contrast their theories. Part VI, "Money: Its Creation and Management," for example, concludes with a presentation of the different views of Milton Friedman and James Tobin on the importance of setting targets for the nation's money supply.

Design and Pedagogy

- Hundreds of two-color graphs are integral to our presentation. The graphs are large and easy to read. Captions carefully summarize the major points in each graph.
- Large flowchart-style diagrams and other illustrations and photographs enhance the visual appeal of the book.
- Key terms are printed in the margins and listed at the end of each chapter so that students can review material systematically.
- All key terms are also gathered in a complete glossary at the end of the book. A text page reference is provided for each glossary entry.
- Each chapter concludes with a concise chapter "Summary" and a useful selection of "Questions for Review and Discussion."

Organization

Economics, Second Edition, is divided into eight parts. In the general sequence, microeconomics precedes macroeconomics. We believe this is the most effective ordering for introductory courses, since many of the issues in macroeconomic theory have their roots in microeconomics. We realize, of course, that many instructors prefer to teach macroeconomics first, and the text allows either to be taught first. In other words, a student can move directly from Chapter 4, "Markets and Prices: The Laws of Demand and Supply," or Chapter 5, "Elasticity," to Chapter 21, "Macroeconomics: Contemporary Problems and Issues," without any loss in continuity.

Introduction

Part I of *Economics, Second Edition*, is a general introduction to the basic tools of economic analysis, including opportunity cost, marginal analysis, comparative advantage, supply and demand, market equilibrium, and elasticity. We have packed these chapters with lively, interesting issues and applications. Chapter 2, for instance, looks briefly at the effects of trade barriers, and in Chapter 4 a discussion of drugs and drug enforcement illustrates how supply and demand and relative prices may be used to explain some features of a critical social problem.

Microeconomics

Part II begins the formal presentation of microeconomic theory. It covers consumer choice, the firm, the firm's costs of production, and output market structures. Although the sequence and coverage of these chapters is relatively standard, we do include a number of innovations. Chapter 7, "The Firm," for example, introduces students not only to the various firm structures but also to the broader economic questions of why firms exist, what roles they serve, and why they take the forms they do. Chapter 9, "The Competitive Firm and Industry," introduces students to the concept of rivalrous behavior, to the dynamic process of competition as well as to the more static model of "pure" competition, and to the role of speculators in competitive markets. Chapter 11, "Monopolistic Competition, Oligopoly, and Cartels," explores recent theory about cartel behavior, relating this theory to problems now experienced by OPEC.

Part III covers demand and supply in factor markets for labor, land, and capital. Perhaps the most unusual chapter in this section is Chapter 15, "Rents, Profits, and Entrepreneurship," which, among other things, investigates the modern theory of rent-seeking behavior and the special role entrepreneurial ability plays in our economy. In this chapter we profile the remarkable careers of a well-known computer entrepreneur, Bill Gates. Part III closes with a detailed look at the issue of income distribution, including a careful examination of economic discrimination against women and minorities.

In Part IV we integrate microeconomic theory and public policy. We cover four broad areas: industry concentration, market failure, taxation, and public choice. Chapter 17, "Market Structure and Public Policy," traces the evolution of antitrust policy from the days of the Standard Oil trust to the present era of decontrol. Chapter 18, "Market Failure and Public Policy," applies the modern theory of externalities to such diverse problems as endangered species, international defense alliances, and shrinking oil reserves as well as the familiar smoke-belching factory. Chapter 19, "The Microeconomics of Taxation," lays the groundwork for understanding recent tax reform in the United States. Chapter 20, "The Theory of Public Choice," shows how economic analysis yields startling new insights into the political decision-making process. Students will discover, for example, one of the reasons why lobbyists are such a major part of our political machinery.

Macroeconomics

In Part V, which opens with Chapter 21, "Macroeconomics: Contemporary Problems and Issues," and Chapter 22, "Measuring the Macroeconomy," the basic tools of macroeconomics are considered: concepts such as real and nominal GNP, two-flow models of national income, price indexes, and aggregate demand and aggregate supply. In Chapter 23, "From Classical to

Keynesian Theory,” we begin our presentation of formal macroeconomic models of the economy. Chapter 23 offers a fuller than usual treatment of Classical theory as a prelude both to Keynes and to modern theories of aggregate supply. The basic Keynesian approach to private consumption and investment begins in Chapter 23 and concludes in Chapter 24, “Output Fluctuations and the Public Sector.” After we have built the Keynesian model for income determination, we conclude Chapter 24 with a pertinent look at recent proposals for a balanced budget and their possible effects under Keynesian theory. Chapter 25, “Aggregate Demand, Aggregate Supply, and Fiscal Policy,” introduces the variable price model for income determination. At the conclusion of this chapter we consider the effects of fiscal policies on aggregate supply and introduce the idea of “supply-side” economics and the emergence of the rational expectations hypothesis. Chapter 26, “Aggregate Supply Principles,” investigates how market conditions for labor and labor expectations help determine supply-side shifts. For instructors who prefer not to cover these concepts in depth, Chapter 25 can stand alone as a complete introduction to aggregate supply/aggregate demand analysis.

Part VI is a complete introduction to money, monetary institutions, monetary policy, and monetary theory. We devote particular attention to the enormous changes occurring within our financial institutions, including the effects of the Monetary Decontrol Act of 1980 and the changing role of commercial banks within the financial system. Unlike most introductory texts, we devote a complete chapter, Chapter 29, to the monetary tools of the Federal Reserve. In Chapter 30 we present the elements of the modern quantity theory of money and the monetarist approach to inflation. The “Economics in Action” for Chapter 30 highlights the current debate over monetary policy.

The four chapters of Part VII extend macroeconomic theory into current policy debates. Chapter 31 reviews for students three separate models of the macroeconomy—the Keynesian theory, the monetarist theory, and the rational expectations theory—and shows how each leads to various fiscal and monetary policies. In Chapter 32 we examine public policy on the problems of inflation and unemployment. Chapter 33 analyzes the macroeconomic implications of the Tax Reform Act of 1986 along with the fiscal effects of deficits and the debt. In Chapter 34 we discuss policy in relation to business cycles. Part VII ends by focusing on the issue of long-term economic growth and the possible reasons for the slowdown of U.S. growth rates in the 1960s and 1970s.

International Trade and Economic Development

Part VIII concludes the book with three chapters on international trade, international finance, and comparative economic systems and development. Chapter 36 applies the basic theory of comparative advantage to an analysis of tariffs and quotas. The “Economics in Action” for this chapter examines how protectionist sentiments are related to so-called voluntary export restraints. Chapter 37 covers many of the most pressing international financial problems, including the recent debt problems of several Third World countries. Finally, Chapter 38 analyzes the relationship between a country’s economic system of incentives and its economic growth. We take a close look at proposed economic reforms in the Soviet Union and at actual reforms in China. We also examine the various problems of economically underdeveloped countries.

The Complete *Economics* Package

- *Economics, Second Edition*.
- *Microeconomics, Second Edition*, and *Macroeconomics, Second Edition*, paperback split volumes of the hardcover text. International trade and development chapters are included in both volumes.
- The *Test Bank* to accompany *Economics, Second Edition*, includes over 3,000 multiple-choice items that test students in recall, inference, calculation, and graph interpretation.
- All test items are available on microcomputer software.
- The student *Study Guide* to accompany *Economics, Second Edition*, helps students review and relearn key concepts and provides a broad assortment of exercises and applications to test and reinforce student understanding. Each chapter in the guide is divided into six parts: "Chapter in Perspective," "Learning Objectives," "Review of Key Concepts," "Helpful Hints," "Self-Test," and "Something to Think About." Split volumes of the *Study Guide* are available to accompany *Microeconomics, Second Edition*, and *Macroeconomics, Second Edition*.
- The *Instructor's Manual* to accompany *Economics, Second Edition*, includes brief introductions to the rationale and scope of each chapter, a complete list of suggested readings for each chapter, and additional teaching resources.
- Two-color overhead transparencies.

Acknowledgments

No revision of this scope can be undertaken or executed without a great deal of help and advice. Ours is certainly no exception. A large number of "official" reviewers were invaluable in improving the quality of our work, and we express our deep gratitude to them. In the category "friendly unofficial critics," we gratefully acknowledge the advice of the following: Richard Ault, Don Bellante, Andy Barnett, Raymond Battalio, Steve Caudill, Charles DeLorme, Roger Garrison, Randy Holcombe, George Horton, John Jackson, Mark Jackson, Dave Kaserman, Jim Long, Charles Maurice, François Melese, Steve Morrell, Richard Saba, and David Whitten. For special help and assistance we wish to thank Gary Anderson, Bob Hebert, Bill Shughart, and Mark Thornton. To our friend Keith Watson, who wrote the *Study Guide* and the *Instructor's Manual* and who provided expert assistance throughout the entire project in both editions, we owe a very special debt.

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RBE and RDT

Suggested One-Semester and One-Quarter Outlines for *Economics, Second Edition*

Chapters	Micro Emphasis	Macro Emphasis	Contemporary Problems and Policy Emphasis	Combined Micro- Macro Emphasis
1 Economics in Perspective	•	•	•	•
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4 Markets and Prices: The Laws of Demand and Supply	•	•	•	•
5 Elasticity	•	•	•	•
6 The Logic of Consumer Choice and Demand	•		•	•
7 The Firm	■			■
8 Production Principles and Costs to the Firm	•		•	•
9 The Competitive Firm and Industry	•		•	•
10 Monopoly: The Firm as Industry	•		•	•
11 Monopolistic Competition, Oligopoly, and Cartels	■			
12 Marginal Productivity Theory and Wages	•			•
13 Labor Unions	■			
14 Capital and Interest	■			
15 Rents, Profits, and Entrepreneurship	•			•
16 The Distribution of Income	•			•
17 Market Structure and Public Policy	•		•	•
18 Market Failure and Public Policy	•		•	■
19 The Microeconomics of Taxation	•		■	
20 The Theory of Public Choice	•			
21 Macroeconomics: Contemporary Problems and Issues		•	•	•
22 Measuring the Macroeconomy		•		
23 From Classical to Keynesian Theory		•	•	•
24 Output Fluctuations and the Public Sector		•	•	•
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26 Aggregate Supply Principles		•		
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29 The Federal Reserve System		•		■
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32 Inflation and Unemployment		•	•	•
33 Fiscal Policy, Taxation, and the Debt		•	•	•
34 Business Cycles		■	■	
35 Economic Growth and Productivity		■		
36 International Trade	•	•		■
37 The International Monetary System		■		
38 Economic Systems and Economic Development		■	•	

• Recommended for both one-semester and one-quarter courses

■ Recommended for one-semester course but optional for one-quarter course

A Note to Students

We have designed special features in *Economics, Second Edition*, that make it easier for you to preview, read, and review the contents of each chapter. Become acquainted with these features and you will give yourself a better chance to succeed on quizzes and exams.

Before you read each chapter, take a few minutes to preview its topics. Begin with the brief chapter overview in the first few paragraphs. Then glance over the section headings and subheadings and read over the chapter summary at the end. After reading the chapter through slowly for the first time, check your comprehension by using the review questions and the list of key terms at the end of each chapter. Reading the “Focus” boxes and the “Economics in Action” box is another good way to test your understanding of concepts. (The *Study Guide* to accompany *Economics* includes a section of additional “Helpful Hints” for each chapter.)

During your second reading, be sure to go over each graph and table in detail, reading the caption and rereading the text description slowly. Try to ask yourself questions as you read and review each graph, and try drawing the graph yourself. After reading the chapter a second time, test your comprehension by going over the end-of-chapter questions and working through the problems there. (The *Study Guide* contains additional short-answer problems.)

Before each quiz, use the key term definitions printed in the margins to help you review chapter concepts. Also reread the chapter summary. (The *Study Guide* includes a sample selection of multiple-choice test items for each chapter.) With these tools at hand, you should find the study of economics a bit less of a chore!

Good luck in the course, and if you have either compliments or complaints about the book, please write to us and pass them along.

Finally, we hope that you will come to enjoy economics as much as we do. Economics is a way of thinking that offers insights about human behavior in a large variety of settings. No matter what you want to be in life—a doctor, a lawyer, an engineer or a poet—the knowledge that economics offers can only be helpful to you.

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