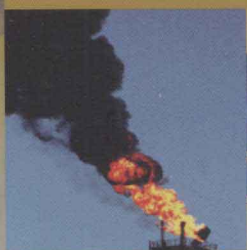


6th Edition

# ECONOMICS AND CONTEMPORARY ISSUES

Edgmand Moomaw Olson



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Sixth Edition

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**Economics and Contemporary Issues, 6e**

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## ■ Preface

*Economics and Contemporary Issues*, Sixth Edition, takes an issues approach to introductory economics. The result is a user-friendly textbook that illustrates how knowledge of economics will help students make more sense of the world. The economy affects us personally and socially. An understanding of the way it works is crucial in personal planning and in making political and social decisions.

This book examines major issues, such as those pertaining to education, medical care, Social Security, unemployment, inflation, and international trade. It provides answers to questions such as: Is education a good investment? What causes inflation? What are the benefits and costs of international trade? It also examines social and political phenomena that will have continued importance in the twenty-first century—the collapse of communism and central planning, the role of government in a modern economy, crime and drugs, poverty, and the failure of some economies to grow.

This textbook maximizes the advantages of the issues approach by examining issues that interest students, while developing core economic principles that provide penetrating insights and a basis for lifelong learning. An economic analysis of contemporary issues will often challenge students' deeply held beliefs about how the world works. Such challenges, combined with the analytical framework provided by economic theory, make this textbook ideal in a curriculum emphasizing critical thinking.

Students who study this textbook will develop an increased interest in economics, seeing it as important in understanding issues that affect them personally, as well as in understanding today's headlines. Experience has shown that students will often study additional economics as a result of using this book.

## ■ THE INTENDED AUDIENCES

One audience for this textbook is students enrolled in the growing number of one-term issues courses offered by economics departments, often as general education courses. This book contains enough economic theory, however, for the traditional one-term survey course in economics. It is also appropriate for use as a supplement in traditional two-semester principles courses or as a text for the economics part of social science survey courses. If the instructor adds other readings (and ample references are provided on the text's Web site), it can also be used as a core text in an upper-division issues or capstone course.

## ■ FEATURES

*Economics and Contemporary Issues* has several features that are important in an issues-oriented text:

- Effective aids to self-learning
- A balanced treatment of microeconomics and macroeconomics
- A basic theory core
- Up-to-date, comprehensive background information on each issue

- Flexibility in the sequencing of topics and issues
- An emphasis on globalization

### Effective Aids to Self-Learning

The first route to self-learning is a clear, concise exposition of basic concepts. *Economics and Contemporary Issues* is readily understood by beginning students. Every sentence has been written with them in mind.

To understand economics, students must master its basic vocabulary. To facilitate this, key terms are highlighted when they first appear and defined in three places: the body of the text, the margin, and the glossary. In addition, each chapter ends with a list of the key terms introduced in the chapter as a reminder to the reader.

To help students master the standard tools of economic analysis, there is a judicious use of graphs and tables that are carefully explained both in their accompanying captions and in the text narrative. The initial graphs are constructed from accompanying data to help the beginner master this important tool of economic analysis.

“Insights” and “International Perspective” features are provided to supplement text material and to illustrate the broad applicability of economics. For instance, one feature discusses the well-known coffee-houses in the Netherlands and another asks whether the college a student attends makes a difference in future earnings.

Self-testing is an essential component of self-learning. Each chapter contains review questions (with answers in the *Instructor's Manual*), and a carefully constructed *Study Guide* is available. Each chapter provides a summary of important points.

Most of today's students are computer-literate and familiar with the Internet as a source of information. This text helps the student (and instructor) tap this resource by providing a large number of references to Web sites related to the issues addressed in this book. In addition, this edition provides text adopters with access to InfoTrac® College Edition, a database of more than a million articles. Keywords to help the reader search this database effectively are provided in the margins of the text.

### A Balanced Treatment of Microeconomics and Macroeconomics

The analysis of macroeconomic issues is often slighted in issues books. Not in this one. Seven of the 18 chapters cover macroeconomic issues, including national income accounting, unemployment, inflation, the federal deficit and debt, the balance of payments and trade deficits, and economic growth. The microeconomic aspects of agriculture, monopoly power, medical care, crime, pollution, education, Social Security, and poverty are also examined.

### A Basic Theory Core

Both the micro and macro parts of this book use a small number of understandable, yet powerful, economic concepts and models.

In the microeconomics chapters, supply-demand and marginal analysis are used extensively. Models of competitive and monopolized markets are developed. The distinctions between social and private benefits

and costs are used to analyze market and government failures. Measures of consumers' and producers' surpluses are used to illustrate efficiency gains and losses.

The basic macroeconomics tool is the model of aggregate supply and aggregate demand. Use of this versatile model enables beginning students to understand the forces that determine output, employment, the price level, and the effects of alternative fiscal and monetary policies (such as proposed changes in taxes and the Federal Reserve discount rate).

### **Up-To-Date, Comprehensive Background Information on Each Issue**

Our experience shows that most beginning students know too little about economic history, data, and institutions. An issues course must fill this void by providing the information necessary for understanding the nature and significance of the problems addressed.

Essential information can be provided by both the instructor and the textbook. Although there is no perfect substitute for an instructor who seeks new information and provides it to students, this book simplifies the instructor's quest by providing current and comprehensive background information on each issue and references to additional resources.

### **Flexibility in the Sequencing of Topics and Issues**

This book is structured so that microeconomic principles (and issues) are examined before macroeconomic principles are introduced. Macroeconomic principles and issues can be studied first, however, because they have been designed to be independent of the micro chapters. Instructors who prefer to teach macro first, following an introduction to the market system, can do so by assigning Chapters 1 and 2 and then going to Chapter 13.

Chapters 1 and 2 provide the foundation for Chapters 3 through 12. Chapter 13 provides the foundation for Chapters 14 through 17. A one-term principles survey course could include Chapters 1 through 5, 13 through 17, and other selected chapters to fit the instructor's interests.

### **An Emphasis on Globalization**

Chapter 1 examines economic growth from an international perspective, and the last two chapters analyze international trade and finance. Today, however, most issues have a global dimension, and the book reflects this. In almost every chapter, students will find an "International Perspective" feature or a section dealing with an international dimension of the issue.

## **■ NEW TO THIS EDITION**

Economic problems and issues change rapidly, requiring frequent updating of data and information. For the sixth edition of *Economics and Contemporary Issues*, we have gone back to the drawing board in more than one-half of the chapters to produce a new edition that is truly different from its predecessors. Of course, we have at the same time done the standard things expected in a revision: updating all of the data, tables, and figures; clarifying explanations; and including more examples and illustrations. The boxed material that complements the main text by providing additional "Insights" and "International Perspective" has also been revised and expanded. The number of references to Web sites has been greatly expanded as well, reflecting

the growing importance of the World Wide Web as a source of current, comprehensive, and readily accessible information on the issues addressed in this book.

The power of the Internet has been multiplied in this edition by providing text adopters with access to InfoTrac® College Edition, a database of more than a million articles. Keywords are provided in the margins of the text.

**CHAPTER 1 ECONOMIC GROWTH: AN INTRODUCTION TO SCARCITY AND CHOICE.** We begin the text with an analysis of economic growth, arguably the most important economic and social phenomenon of the last 200 years. The title reflects the fact that even rapidly growing economies are not relieved of the necessity to choose among alternative uses of scarce resources. The relationships between growth, scarcity, and choice are illustrated with the production possibilities curve. The critical role of productivity in the growth process is highlighted, and recognition is given to the development of the “New Economy” as a source of recent U.S. economic growth.

**CHAPTER 2 AN INTRODUCTION TO ECONOMIC SYSTEMS AND THE WORKINGS OF THE PRICE SYSTEM.** This chapter compares the experiences of the Eastern European transition economies to the benchmark of a competitive market system. This edition places increased emphasis on the importance of property rights and honesty (minimum corruption) in determining the success of the transition to a market economy. The discussion and graphics are simplified by focusing most of the discussion on four representative countries.

**CHAPTER 3 INEFFICIENCY: THE PERVERSIVE ECONOMIC PROBLEM.** This is a new chapter, although it incorporates some of the material that was in Chapter 12 of the previous edition. It identifies inefficiency as an important (rivaling unemployment, inflation, growth, and so forth) and pervasive (endemic to both the private and public sectors of the economy) problem. The problem is illustrated with a number of examples of inefficiency in the private sector, or market failure, and a number of examples of inefficiency in the public sector, or government failure. Most of the examples are illustrated graphically. Efficiency losses and gains are identified and measured as areas in supply and demand diagrams.

**CHAPTER 4 COMPETITIVE MARKETS AND AGRICULTURE.** As indicated by the change in title (from the former “US. Farm Policy: How Is It Changing?”), this chapter has an increased emphasis on competitive markets. This allows users to downplay agriculture and agricultural policy and expand on the economics of competitive industries. The chapter has a discussion of the 1996 Farm Reform Bill and argues that we are continuing with the failed policies of the last 50 years, but it does not go into detail on the new farm bill. An appendix on the price elasticity of demand has been added.

**CHAPTER 5 MARKET POWER: DOES IT HELP OR HURT THE ECONOMY?** This analysis of the economics of market power continues to focus heavily on two important contemporary examples, the Microsoft antitrust case and the OPEC oil cartel. Both examples are brought up to date. The role of the OPEC cartel in influencing oil prices at the end of the 1990s is thoroughly discussed.

**CHAPTER 6 AIR POLLUTION: BALANCING BENEFITS AND COSTS.** This chapter has been completely revised, and more than one-half of the material is new to this edition. The economists’ perspective on the pollution problem has been condensed into one supply-demand diagram that illustrates and quanti-

fies the efficiency losses from pollution. This diagram is also used to illustrate how the Coase theorem works. New data are presented on the progress made in reducing air pollution under the Clean Air Act, and there is a new section on the benefits and costs of the Clean Air Act. The section on pollution taxes and emissions permits has been completely revised, using an example that illustrates the cost savings possible with these approaches.

**CHAPTER 7 MEDICAL CARE: COSTS OUT OF CONTROL?** This chapter has also been thoroughly revised, prompting the change in title from “Health Care Reform: How Much?” in the previous edition. The chapter begins with a new section in which the rising cost of medical care is discussed in terms of Baumol’s Cost Disease Theory, population aging, income elasticity of demand for health care, increases in insurance coverage, and technological change. This is followed by another new section in which the benefits and costs of technological change—the primary cause of rising medical costs—are examined. Evidence indicates that the benefits of medical advances far outweigh the costs; other evidence indicates that economic incentives induce Americans to overuse medical care at the same time that they are reaping the benefits of medical advances.

**CHAPTER 8 CRIME AND DRUGS: A MODERN DILEMMA.** This chapter continues to highlight the economic approach to crime. The primary change from the previous edition is the addition of a discussion of the economics of controlling terrorism.

**CHAPTER 9 COLLEGE EDUCATION: IS IT WORTH THE COST?** This chapter remains built around a numerical example of the benefits and costs to a typical college graduate from investing in a college education. New diagrams based on this example have been added, however. The discussion of nonmonetary benefits and costs has been condensed, and the section “Is Government Support Necessary?” has been thoroughly revised. A new supply-demand diagram has been added to illustrate why government support of higher education is necessary to achieve the right number of college graduates. A new time series diagram has been added to illustrate how a student loan affects the payoff from investing in a college education.

**CHAPTER 10 EDUCATIONAL REFORM: THE ROLE OF INCENTIVES AND CHOICE.** This chapter has been thoroughly rewritten, but its purpose remains that of demonstrating how economics can illuminate the debate on reforming U.S. elementary and secondary education. Special attention continues to be given to the role of tougher educational standards and the possibilities afforded by greater reliance on educational choice.

**CHAPTER 11 SOCIAL SECURITY: WHERE ARE WE? WHERE ARE WE GOING?** Much of this chapter is new. All of the data have been updated to reflect the latest program information, and all of the projections have been changed to reflect the *2002 Annual Report* of the Social Security Trustees. A numerical example has been added to illustrate the principal steps taken to determine Social Security retirement benefits. New time series diagrams have been added to illustrate the benefits and costs of investing in Social Security, and the latest projections of the Social Security Trust Fund. There is a new discussion of the relationships between the Social Security surplus, national saving and investment, and the long-run Social Security deficit. The section on privatization has been rewritten, and a new section has been added to illustrate that the rate of return on Social Security depends on how the long-run deficit problem is solved.

**CHAPTER 12 POVERTY: OLD AND NEW APPROACHES TO A PERSISTENT PROBLEM.** About two-thirds of the material in this chapter is new. Several time series diagrams have been added to illustrate trends in the official poverty rate, the poverty rates of selected groups, the pre-transfer poverty rate, the antipoverty effectiveness of government transfers, and the relationship of poverty and unemployment. There is a new analysis of the relationship between means-tested transfers and income from work, featuring the separate and combined effects of food stamps, the earned income tax credit, and the Temporary Assistance for Needy Families (TANF) program. New sections have been added on childcare assistance and medical protection for individuals making the transition from TANF to work. The final section throws the spotlight on efforts toward a more effective system of child support.

**CHAPTER 13 TRACKING THE MACROECONOMY.** The basic text of this chapter continues to be devoted to the elements of measuring national output and the price level. The primary changes in the sixth edition are in the “Insights” features. The feature on GDP and social welfare incorporates a discussion of the economics of terrorism. The material on the underground economy has been thoroughly updated, and there is a new feature on the “long boom”—the nearly uninterrupted expansion in the U.S. economy from 1982–2001.

**CHAPTER 14 UNEMPLOYMENT: A RECURRING PROBLEM.** The basic aggregate demand–aggregate supply framework of this chapter remains intact. A new “International Perspective” feature on European labor markets has been added.

**CHAPTER 15 INFLATION: A MONETARY PHENOMENON.** This chapter continues to analyze inflation using both the equation of exchange and the aggregate demand–aggregate supply model. There is a new “International Perspective” feature on the increasingly important problem of deflation in Japan.

**CHAPTER 16 DEFICITS, SURPLUSES, AND DEBT: PAST, PRESENT, AND FUTURE.** This is the most thoroughly revised chapter in the text. The overall objective of the revision is to address the budget deficit issues currently being debated in Washington, using the concepts and measures featured in that debate. The chapter incorporates a new section on the components of the federal budget that distinguish between different types of deficits and surpluses. There is an expanded historical review of the deficit and recent surpluses, using new time series diagrams. There is another new section that explains and illustrates the relationships between the public debt, the national debt, and the net budget balance. Projections of net budget balances and the public debt are incorporated in the text for the first time, as is a discussion of the controversial issue of how to measure the deficit.

**CHAPTER 17 THE GLOBAL ECONOMY: TRADE.** This chapter provides updated data, and a new time series diagram of the trade deficit has been added. The most substantive change, however, is the addition of a supply-demand analysis of the gains from trade, using the concepts of consumers’ and producers’ surpluses. This part of the chapter gives readers a final opportunity to reinforce their knowledge of what economists mean by efficiency losses and gains, and it provides additional support for a policy of free trade.

**CHAPTER 18 THE GLOBAL ECONOMY: FINANCE.** This chapter also provides updated data, as well as several changes to clarify the exposition of difficult points. As in the previous edition, the chapter contains discussions of fixed exchange rates, flexible versus fixed exchange rates, the European Monetary Union, the euro, and the Asian financial crisis.

## ■ SUPPLEMENTARY MATERIALS

- <http://edgmand.swlearning.com> is the address of the text's Web site. It provides access to Online Quizzes, CyberProblems, each chapter's list of Suggestions for Further Reading, the Internet addresses for each chapter, Author Updates, links to the EconApps (Economic Applications) Web site, and much more.
- <http://econapps.swlearning.com> is the site of South-Western's dynamic economics Web features: EconNews Online, EconDebate Online, and EconData Online. Organized by topic and searchable by topic or feature, EconApps are easy to integrate into the classroom. EconNews, EconDebate, and EconData all deepen your understanding of theoretical concepts through hands-on exploration and analysis of the latest economic news stories, policy debates, and data. These features are updated on a regular basis. The Economic Applications Web site is complimentary to every new book buyer via an access card packaged with the books. Used-book buyers can purchase access to the site at <http://econapps.swlearning.com>.
- InfoTrac® College Edition is packaged as an access card with every new copy of the textbook. It is a fully searchable online university library containing complete articles and their images. Its database allows access to hundreds of scholarly and popular publications—all reliable sources—including magazines, journals, encyclopedias, and newsletters.
- The *Study Guide*, revised by Dale G. Bails, Christian Brothers University, contains a list of objectives, review of key terms, quantitative problems, true/false questions, multiple-choice questions, and fill-in questions for each chapter.
- The *Instructor's Manual/Test Bank*, thoroughly revised by Hamid Azari-Rad of SUNY, New Paltz, provides instructors with useful tools for planning their courses and preparing exams. The *Instructor's Manual* includes chapter overviews, teaching objectives, key terms, teaching suggestions, additional references, detailed lecture outlines, and answers to review questions. The *Test Bank* provides a variety of exam questions and problems in true/false, multiple-choice, and essay and discussion formats. Chapters also include critical thinking multiple-choice questions. Both are available—password protected—to instructors on the text's Web site.
- ExamView – Computerized Testing Software contains all of the questions in the printed test bank. This program is an easy-to-use test creation software compatible with Microsoft Windows. Instructors can add or edit questions, instructions, and answers, and select questions by previewing them on the screen, selecting them randomly, or selecting them by number. Instructors can also create and administer quizzes online, whether over the Internet, a local area network (LAN), or a wide area network (WAN).
- The *Instructor's Activity Manual* contains group activities to facilitate understanding of each chapter. Each activity is designated by type, topic, class size, and time needed, and includes instructions and relevant questions. The activity manual is available on the text Web site, password protected, to instructors.
- Encouraging students to use the World Wide Web to further their studies can sometimes be a challenge. *Economics HITS on the Web* is designed to do just that. This supplement offers a reader-friendly

overview of the various aspects of the Internet and gives students a good grasp on browsing, searching, and communicating online with more than 50 links that are specific to the study of economics.

- The shape, pace, and spirit of the global economy has been greatly impacted by the events that occurred on September 11, 2001. *9/11: Economic Viewpoints* offers a collection of essays that provide a variety of perspectives on the economic effects of these events. Each essay is written by one of South-Western's economics textbook authors, all of whom are highly regarded for both their academic and professional achievements. This unique collaboration results in one of the most cutting-edge resources available to help facilitate discussion of the impact of 9/11 within the context of economics courses.

## ■ ACKNOWLEDGMENTS

This book is a joint product of three authors who are long-time colleagues and friends. We did not produce this book alone, however, and we greatly appreciate the contributions of users, colleagues, reviewers, students, and the editorial team at Thomson Learning/South-Western. We appreciate all comments that we receive and rely on them as we make revisions. Please let us know how we can improve our book.

Many of the changes in this edition were made in response to the careful reviews and thoughtful suggestions of Joseph Horton (University of Central Arkansas); John P. Manzer (Indiana University–Purdue University, Ft. Wayne); Melanie Marks (Longwood College); Gary L. Stone (Winthrop University); Randall Holcombe (Florida State University); Daphne T. Greenwood (University of Colorado, Colorado Springs); and Manjuri Talukdar (Northern Illinois University). We are grateful for their help, as well as for the help of the reviewers of previous editions: Michael Applegate (Oklahoma State University); Steven Petty (College of the Ozarks); Michael W. Babcock (Kansas State University); Fred J. Ruppel (Eastern Kentucky University); Gary L. Stone (Winthrop University); Rebecca Summary (Southeast Missouri State University); John P. Blair (Wright State University); Eric Brooks (Orange County Community College); Bruce Domazlickey (Southeast Missouri State University); Robert B. Harris (Indiana University–Purdue University at Indianapolis); Philip J. Lane (Fairfield University); John Merrifield (University of Texas–San Antonio); Paula Smith (University of Central Oklahoma); John Scott (Northeast Louisiana University); Charles Stull (Western Michigan University); Millicent Taylor (University of Southern Colorado); Ugur Aker (Hiram College); Gale Blalock (University of Evansville); James R. Frederick (Pembroke State University); Christopher Lingle (Loyola University–New Orleans); Edwin A. Sexton (Virginia Military Institute); Ranbir Varma (Long Island University); Pauline Fox (Southeast Missouri State University); Neil Garston (California State University–Los Angeles); Doug McNeil (McNeese State University); John Pisciotta (Baylor University); Steve Smith (Rose State College); Barbara Street (Chaminade University–Honolulu); Hyung C. Chung (University of Bridgeport); Emily Hoffman (Western Michigan University); George Murphy (University of California–Los Angeles); Larry Sechrest (University of Texas–Arlington); and Alden Smith (Anne Arundel Community College).

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They have greatly facilitated the development of this edition. We certainly could not have done it so quickly—or so well—without them.

All of our children have by now reached the age where the preparation of yet another edition does not come at the expense of time spent with them, but our wives—Judy, Julie, and Carol—continue to willingly bear some of the opportunity costs of this project. Their support and encouragement has been an invaluable asset, and they deserve the biggest thanks of all.

**Michael R. Edgmand**

**Ronald L. Moomaw**

**Kent W. Olson**

## To the Student

Welcome to *Economics and Contemporary Issues*, Sixth Edition. This book will teach you how the American economy works and how economic incentives and institutions are related to important social problems. In the process of learning these things, you will sharpen your critical thinking skills.

The issues and problems you will study command the attention of concerned citizens and policy makers. Many of them will continue to be important long after you have finished this book; some will, hopefully, fade away. The principles you learn here, however, will help you to understand new problems and issues as they appear.

In examining each issue, we develop and apply the principles essential for understanding its economic dimensions, and then evaluate current and alternative approaches to dealing with it. The first step is the province of positive economics; the second is the focus of normative economics. Positive economics explains and predicts economic phenomena; normative economics selects social goals and evaluates policy alternatives according to how well they achieve these goals. This approach reflects the dual purpose of economics: to discover how the world works and to determine how it can be improved.

The basic normative questions posed throughout this book are whether government action is necessary to solve social problems and, if so, what policies should be adopted. For example, the chapter on air pollution considers whether curbing pollution—a social goal—can be accomplished efficiently by the private sector alone and concludes that it cannot. Existing regulations and proposed policies are then evaluated to determine which of them are most likely to improve the situation. We use a similar approach in examining the other issues. We hope the net result will be a greater appreciation of the strengths and weaknesses of both the private and public sectors of the economy.

To achieve lasting benefits from economics, and to do well in your course, plan to go beyond merely memorizing this material. Learn, in addition, how to apply the principles and models developed in the text. We have attempted to write clearly and concisely so that you will understand the important principles. You will greatly enhance your ability to apply these principles, however, by answering the questions at the end of each chapter and by working through the *Study Guide*, by Dale G. Bails, that has been written to help you master the material.

Finally, no single text can provide all of the information that pertains to the issues that we address. You can learn much more by examining the Web sites we suggest throughout the text, by exploring recent articles using the InfoTrac® subscription that accompanies your purchase of this text, and by accessing the book's Web site at <http://edgmand.swlearning.com>.

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