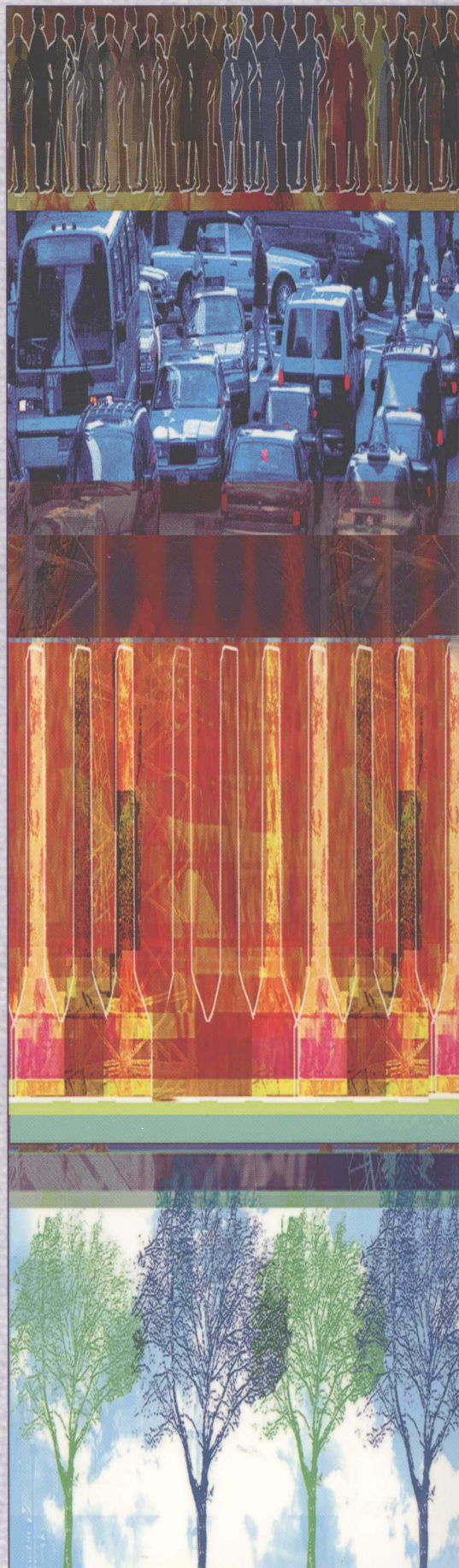


MOOMAW

OLSON

# ECONOMICS & CONTEMPORARY ISSUES

SEVENTH EDITION



# ***Economics and Contemporary Issues***

edition **7**

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*Economics and Contemporary Issues* 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, health care, Social Security, unemployment, inflation, the budget deficit, and international trade. It provides answers to questions such as: Is education a good investment? Are we spending too much on health care? What causes inflation? Are we headed for a federal budget disaster? What are the benefits and costs of international trade? It also examines social and political phenomena that will have continued importance in the 21st 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.

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## 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.

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## A BALANCED TREATMENT OF MICROECONOMICS AND MACROECONOMICS

The analysis of macroeconomic issues is often slighted in issues books, but 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, health 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 and 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 very 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 most chapters, students will find an "International Perspective" feature or a section dealing with an international dimension of the issue.

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## NEW TO THIS EDITION

Economic problems and issues change rapidly, requiring frequent updating of data and information. For the seventh edition of *Economics and Contemporary Issues*, we have literally gone back to the drawing board in over 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 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 Perspectives" has also been revised and expanded. The most extensive change here is the addition of new "Insight" boxes in seven chapters that use basic

economics to examine the effects of Hurricanes Katrina and Rita, and the manner in which the market system and government authorities responded to the crisis that ensued.

The number of references to Web sites has been greatly expanded, 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 again in this edition by providing text adopters with access to InfoTrac<sup>®</sup> College Edition, a database of over a million articles. Keywords to help the reader search this database effectively 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 among growth, scarcity, and choice are illustrated in the usual manner with the production possibilities curve. However, this model is also used in this edition to illuminate choices that the typical college student must make. The chapter also includes a new “Insight,” The Cost of Hurricanes. The critical role of productivity in the growth process is also 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 has two primary purposes: (1) to explain how market systems work, and (2) to examine the experiences of formerly planned economies in their quest to transition to market systems. This edition continues to stress the importance of property rights and honesty in the transition process. The “International Perspective” on China is revised to account for the Land Ownership Law of 1998. A new section on “Comparative Advantage and Specialization” has been added, along with an “Insight” on Wal-Mart and FEMA that discusses how decentralization has advantages over centralization in disaster relief.

**CHAPTER 3 COMPETITIVE MARKETS AND GOVERNMENT POLICY: AGRICULTURE.** This is the former Chapter 4, relocated to immediately reinforce and apply the supply and demand model to competitive markets. This allows users to emphasize the economics of competitive industries other than agriculture. However, there is still up-to-date information on farm programs and an evaluation of their effectiveness. As a concession to student preferences, ramen noodles has replaced hamburger as an example of an inferior good. This edition adds an “Insight” on Price Gouging and the Twin Hurricanes as a case study of how markets operate.

**CHAPTER 4 EFFICIENCY IN RESOURCE ALLOCATION: HOW MUCH DO WE HAVE? HOW MUCH DO WE WANT?** This chapter has been relocated (formerly Chapter 3) and renamed (formerly Inefficiency: The Pervasive Economic Problem). Although the chapter can be understood without an introduction to supply and demand, it can be more easily understood as a follow-up to Chapter 3. This chapter contains essentially the same material as in Chapter 3 of the Sixth Edition; however, it is cast in a more positive tone. It continues to use the concept of welfare gains and losses to illustrate the losses from market failures and government policies and regulations. It also continues to emphasize the trade-offs among efficiency, equity, and growth.

**CHAPTER 5 MARKET POWER: DOES IT HELP OR HURT THE ECONOMY?** This analysis of the economics of market power starts by developing the standard monopoly model. The model is then modified as appropriate and applied to the OPEC oil cartel and to the gasoline market. The section “Market Power and Economic Growth” from the Sixth Edition is thoroughly revised and it is now entitled “Market Power and Technical Progress.” It now encompasses both technological improvements and efficiency improvements. The chapter also has a new “Insight”: Rita, Katrina, and Refineries: Economic and Political Rent Seeking.

**CHAPTER 6 AIR POLLUTION: BALANCING BENEFITS AND COSTS.** This chapter was completely revised for the Sixth Edition and is essentially unchanged for the Seventh Edition. The economist's perspective on the pollution problem is examined with one supply-demand diagram that illustrates and quantifies the efficiency losses from pollution. This diagram is also used to illustrate how Coase's theorem works. Data are presented on the progress made in reducing air pollution under the Clean Air Act, and there is a section on the benefits and costs of the Clean Air Act. The section on pollution taxes and emissions uses an example that illustrates the cost savings possible with these approaches.

**CHAPTER 7 HEALTH CARE: HOW MUCH? FOR WHOM?** This is a thoroughly revised chapter that addresses the principal problems of the U.S. health care system and issues related to reforming that system. The principal problems are: (1) the rising share of GDP devoted to health care; (2) the growing number of uninsured individuals; and (3) wasteful spending. We raise the issue of how much health care the U.S. can afford and examine several ways of rationally limiting expenditures.

**CHAPTER 8 CRIME AND DRUGS: A MODERN DILEMMA.** This chapter continues to highlight the economic approach to crime. A discussion of the threat imposed by methamphetamines has been added. The relative merits of drug treatment versus conducting a war on drugs are also considered from an economic perspective.

**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. The determination of the rate of return from investing in a college education is revised to allow for: (1) the fact that the typical college student spends more than 4 years (4.57) completing a bachelor's degree; (2) the probability that a student will drop out each year (4 percent per year) after enrolling; and (3) the probability of completion within 6 years (58 percent). These revisions reduce the rate of return to both the student and society, but investing in a college education remains an attractive alternative from both perspectives.

**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. The chapter now has a discussion of No Child Left Behind (NCLB), and the analysis of government policy has been revamped to compare accountability (NCLB) and consumer choice. Three "Insights" have been added: Effects of High-Stakes Testing on Achievement, School Choice, and Choice and Sorting.

**CHAPTER 11 POVERTY: NEW APPROACHES TO AN OLD PROBLEM.** The analysis of the issues raised in this chapter depends heavily on the use of data on poverty measures and programs. All the data, figures, and tables have been revised to reflect the latest available information. Time series diagrams are used extensively 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 an improved 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. The sections on childcare assistance and medical protection for individuals making the transition from TANF to work have been revised, and the final section continues to focus on efforts to develop a more effective system of child support.

**CHAPTER 12 TRACKING AND EXPLAINING THE MACROECONOMY.** This title change (from Tracking the Macroeconomy) more accurately describes the contents of the chapter as one devoted both to measuring output and prices and to developing the model of aggregate supply and aggregate demand. The "Insight" Real GDP and Social Welfare has been modified to include the effects of hurricanes.

**CHAPTER 13 UNEMPLOYMENT: THE LEGACY OF RECESSION, TECHNOLOGICAL CHANGE, AND FREE CHOICE.** This chapter has remained essentially unchanged for several editions. That is no longer the case. The title change is intended to reflect the fact that there are three primary sources of unemployment. The relationship between full employment and the natural rate of unemployment is carefully explained and illustrated. The chapter now distinguishes more clearly between active and passive macroeconomic policy. There is an “Insight” on the effects of Hurricanes Katrina and Rita on the economy. An appendix on the labor market has been added, with the demand curve reflecting the marginal product of labor and the supply curve reflecting the trade-off between work and leisure. This material can be used to explain the links among unemployment, government actions to combat unemployment, and the degree of wage flexibility. It can also be used to more fully explain the economics of the minimum wage (developed in this chapter) and the causes of poverty (Chapter 11).

**CHAPTER 14 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 discussion of the relationship among monopolies, oil markets, and inflation. A new “Insight,” When is an Increase in the CPI Not Inflation? captures the effect of Hurricanes Katrina and Rita on inflation. Another “Insight,” Volcker and Greenspan: Architects of the Long Boom, has also been added.

**CHAPTER 15 SUSTAINED BUDGET DEFICITS: IS THIS ANY WAY TO RUN A GOVERNMENT?** The prospect of large and growing budget deficits is one of the most serious problems facing the U.S. economy. Recognition of the growing importance of this issue makes this the most thoroughly revised chapter in the text. It has been completely rewritten to focus on the causes and macroeconomic consequences of projected chronic budget deficits and expanding debt. It explains why they are not sustainable and examines alternative means of solving the problem.

**CHAPTER 16 SOCIAL SECURITY: LEADING ISSUES AND APPROACHES TO REFORM.** The long-run deficit in Social Security is one the principal causes of the projected long-run federal budget deficit; hence, the new location of this chapter. The chapter retains much of the material explaining Social Security benefits from Chapter 11 of the Sixth Edition. Virtually half the material is new, however, including a discussion of reform plans proposed to fix the existing system and to supplement the system with individual accounts.

**CHAPTER 17 INTERNATIONAL TRADE: BENEFICIAL, BUT CONTROVERSIAL.** This chapter has been rewritten and expanded to explain and illustrate the bases for international trade, the net benefits of trade, controversial aspects of free trade, and the welfare costs of popular cures, such as tariffs and quotas.

**CHAPTER 18 FINANCING TRADE AND THE TRADE DEFICIT.** This chapter has been revised and reorganized to explain how exchange rates are determined and how trade deficits are financed. Then we examine three issues: the effects of growing U.S. foreign indebtedness, the case for and against the regulation of exchange rates, and the case for and against the regulation of international capital flows.

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## 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. Beginning students readily understand *Economics and Contemporary Issues*. 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, there are several “Insights” relating to the effects of and responses to the 2005 hurricanes. Another “Insight” discusses the well-known coffeehouses in the Netherlands, and one asks whether the college that 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 number of references to helpful Web sites. In addition, this edition provides text adopters with access to InfoTrac®, a database of over a million articles. Keywords to help the reader search this database effectively are provided in the margin of the text.

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## SUPPLEMENTARY MATERIALS

- ◆ Student Companion Web Site. Located at <http://moomaw.swlearning.com>, this site provides access to Online Quizzes, Key Terms and Definitions, CyberProblems, Additional Suggested Readings by Chapter, End of Chapter Web Site Addresses, and much more.
- ◆ Economic Applications include EconNews, EconDebates, and EconData features to deepen understanding of theoretical concepts through hands-on exploration and analysis of the latest economic news stories, policy debates, and data. Organized by topic and continually updated, EconApps are easy to integrate into the classroom.
- ◆ InfoTrac® College Edition 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.

If an access card came with this book, you can start using many of these resources right away by following the directions on the card. Get started today at <http://www.thomsonedu.com>

- ◆ The Study Guide, revised by Kenny Christianson of Binghamton University, contains for each chapter a list of objectives, review of key terms, quantitative problems, true/false, multiple-choice, and fill-in questions.

- ◆ The Instructor's Manual and Test Bank, thoroughly revised by Holly Lippke Fretwell of Montana State University, provides instructors with a useful tool in planning their course 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 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.

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## ACKNOWLEDGMENTS

We did not produce this book alone, and we greatly appreciate the contributions of users, colleagues, reviewers, students, and the editorial team at Thomson/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.

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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, Julie and Carol, continue to willingly bear some of the opportunity costs of this project. Their support and encouragement have been invaluable.

Last, but certainly not least, we dedicate this edition to our former colleague and coauthor, Michael Edgmand, now enjoying retirement in the beautiful Pacific Northwest. There is, and will remain, much in the book that reflects his contributions.

**Ronald L. Moomaw**

**Kent W. Olson**



# TO THE STUDENT

Welcome to *Economics and Contemporary Issues*. 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 that Kenny Christianson of Binghamton University has 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 that we suggest throughout the text, by exploring recent articles using the InfoTrac<sup>®</sup> subscription that accompanies your purchase of this text, and by accessing the book's Web site at <http://moomaw.swlearning.com>.

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