

ECONOMICS

*THE OPTIONS
FOR DEALING
WITH
SCARCITY*

Frank D. Tinari



ECONOMICS

| *THE OPTIONS
FOR DEALING
WITH
SCARCITY*

Frank D. Tinari
Seton Hall University

Scott, Foresman and Company
Glenview, Illinois
London, England

Library of Congress Cataloging in Publication Data

Tinari, Frank D., 1943—
Economics—the options for dealing with scarcity.

Includes bibliographical references and index.

1. Economics. I. Title.

HB171.5.T546 1986 330 84-27522

ISBN 0-673-16574-4

Copyright © 1986 Scott, Foresman and Company.

All Rights Reserved.

Printed in the United States of America.

123456-MVN-8988878685

To Barbara, my loyal supporter, my love,
and to her beautiful reflections,
April, Alexandra, and Christa

ACKNOWLEDGMENTS

Box 2-2, p. 39, From *The Morgan Guaranty Survey*, December 1982, p. 14. Reprinted by permission. **Table**, p. 27, Excerpted from *U.S. News & World Report*, December 5, 1977. Copyright © 1977, U.S. News & World Report, Inc. Reprinted by permission. **Box 4-1 and Box 4-3**, pp. 84 and 93, From R.A. Radford, "The Economic Organization of a P.O.W. Camp," *Economica*, Volume XII, 1945, pp. 189–201. Reprinted by permission. **Box 6-1**, p. 140, Reprinted by permission from "Is History Outdated? Outdoor Museums Are Having Trouble" by John Helyar, *The Wall Street Journal*, June 27, 1980. Copyright © 1980 Dow Jones & Company, Inc. All Rights Reserved. **Box 7-2**, pp. 161–62, From Schuettinger and Butler, *Forty Centuries of Wage and Price Controls*, pp. 33–34. Copyright © 1979 by The Heritage Foundation. Reprinted by permission. **Box 7-3**, p. 176–77, From *Human Action* by Ludwig Von Mises. Copyright 1949 Contemporary Books, Inc. Reprinted by permission. **Box 8-2**, p. 195, From "Crowding and Decay Threaten U.S. Parks" by Philip Shabecoff from *The New York Times*, August 3, 1980. Copyright © 1980 by The New York Times Company. Reprinted by permission. **Box 9-3**, pp. 229 and 241, "Believe it—or not?" Reproduced with the permission of the Urban Libraries Council. **Quote**, p. 245, Reprinted from *Fiddler on the Roof* by Joseph Stein. Copyright © 1964 by Joseph Stein. Reprinted by permission of Crown Publishers, Inc. **Box 10-1**, p. 246, From *Giving In America: Toward a Stronger Voluntary Sector*. Report of the Commission on Private Philanthropy and Public Needs, 1975, pp. 9–14. Reprinted by permission of Silverstein and Mullens, Law Offices. **Box 10-4**, p. 259, From *Equality and Efficiency: The Big Tradeoff* by Arthur M. Okun, pp. 91–92. Copyright © 1975 by The Brookings Institution. Reprinted by permission. **Exhibit 11-12**, p. 291, From *The Inequality of Pay* by E. Phelps-Brown.

Copyright © 1977 by University of California Press. Reprinted by permission of University of California Press and Oxford University Press, U.K. **Box 12-1**, p. 307, From "Who Will Make Money in the '80s?" by Chris Welles, *Esquire*, September 1980, pp. 29–31. Copyright © 1980 Esquire Associates. Reprinted by permission. **Cartoon**, p. 321, From the *Wall Street Journal*—Permission, Cartoon Features Syndicate. **Box 13-2**, p. 344–45, From "The Subterraneans" by Peter M. Gutman, *Psychology Today*, April 1980. Reprinted by permission of the American Psychological Association. **Exhibit 14-8**, p. 371, From *The Morgan Guaranty Survey*, February 1979, p. 11. Reprinted by permission. **Box 15-1**, pp. 385–86, Excerpted from *The General Theory of Employment, Interest and Money* by John Maynard Keynes. Reprinted by permission of Harcourt Brace Jovanovich, Inc. and Macmillan, London and Basingstoke. **Box 16-1**, p. 407, "Filthy Lucre" reprinted from the September 1979 issue of *Money* magazine by special permission; © 1979 Time Inc. All rights reserved. **Box 17-1**, pp. 432–33, From "Your Own Inflation Rate" by Ed Henry. Reprinted from the January 1980 issue of *Money* magazine by special permission; © 1980 Time Inc. All rights reserved. **Exhibit 17-3**, p. 429, From E.H. Phelps-Brown and Sheila V. Hopkins, "Seven Centuries of the Prices of Consumables, Compared With Builders' Wage-rates," *Economica*, Volume XXIII, November 1956, p. 299. Reprinted by permission. **Box 18-2**, p. 459, Excerpted from "Are Americans Going Too Deep Into Debt?" *U.S. News & World Report*, August 3, 1981. Copyright © 1981, U.S. News & World Report, Inc. Reprinted by permission. **Exhibit 18-9**, p. 469, From "How Your Taxes Will Change," *U.S. News & World Report*, August 10, 1981. Copyright © 1981, U.S. News & World Report, Inc. Reprinted by permission.

Cover photo: Though her neighbors sold their homes to make way for a new gambling casino on Atlantic City's Boardwalk, Antoinetta Bongiovanni refused. So the casino built around her. Both sides exercised their options.

To The Economics Educator

The separation of topics into macroeconomics and microeconomics, which has facilitated teaching, is becoming strained. . . . More and more, macroeconomic problems seem to stem, at least in part, from microeconomic causes.

Thomas M. Carroll, Microeconomic Theory, 1983

This book covers the landscape found in typical one-term introductory economics textbooks. (Which implies, at the outset, that your use of this book will permit you to continue to present the bulk of what you have been teaching.) Yet, it is markedly different in organization. I have asked myself what I believe to be crucial questions concerning the teaching of introductory economics and have found that existing texts do not provide satisfactory answers. These questions fall into two sets:

1. Why don't economics texts give students a unified picture of reality? How can we assist students in seeing that the many seemingly disparate problems and "economic" issues of continuing concern to society can be organized by economics into a coherent perspective, a perspective that transforms confusion and apparent differences into an integrated, unified view of the world around them?
2. What, after all, are the ultimate objectives of economics? What unique contributions can it make to help students better understand the world around them? How can students practice what they learn in examining issues that confront them daily?

The Problem

In essence, the fundamental problem is that students have not been provided a unified structure with which to examine reality. More often than not, students who complete an introductory course have learned bits and pieces, but seem to be unable to place them all into perspective.

It is true that, structurally, the majority of texts today rely on the macro-micro distinction (with "miscellaneous" topics added on). Admittedly,

this quite valid and useful distinction is more integrative than the text formats generally used before the 1940s in this country, but it has some unfortunate implications. The main problem is that this convenient organizational device has gradually been transformed into a hard-and-fast way of structuring students' thinking about economic issues. To paraphrase McLuhan, the superstructure has become the message. Unfortunately, the message is an artificial one. The results of this subtle transformation include:

1. An undue and misleading emphasis on the dichotomy between the two points of view.
2. A certain awkwardness in bridging the gap between the micro and macro portions of textual material, accompanied by apologies and caveats regarding the micro foundations of macroeconomics.
3. The institutionalization of the macro-micro distinction in the form of the two-term scheduling sequence, and a proliferation of "micro-macro" paperback "splits." At course enrollment time, students at many institutions are told that it doesn't matter which of the two is taken first. The message is that the gap between the two is so complete that they are, in effect, separate subjects.
4. The placement of topics not strictly "macro" or "micro" in various remaining sections of introductory textbooks. Thus we find separate chapters, that appear to have been tacked onto the body of the textbook, focusing on "urban economic issues," "international trade," or "economic growth." What is the serious student to make of all this?

Students come away from an introductory economics course thinking that any problem may be categorized as either macro or micro. Not only is

this unfortunate view too crude, it also misleads students into thinking that this is how economists approach problems. The analytical distinction between partial and aggregate equilibrium is an important but by no means the only important distinction in economic analysis. It certainly isn't an all-encompassing one. Surely we can do better than this.

A potential alternative pedagogical device, namely, the "fundamental questions which every economic system must answer," is often placed in an early chapter of introductory texts, but promptly dies on the vine. The familiar what-how-for whom trilogy originally consisted of five distinct functions in Frank Knight's *The Economic Organization* (1951). Yet, if these are so fundamental, why do most texts treat them briefly at the outset, and then return to them only briefly, if at all, in succeeding chapters? The "fundamental questions" framework has the potential of enabling authors to unify the topics treated in their texts, but the potential is not realized. (The framework of this book, as explained below, incorporates these fundamental questions in a way that shows explicitly how they relate to one another.)

I believe a more cohesive setting is needed within which to teach economic concepts and theories. Such an organizational structure should incorporate, not discard, macro and microeconomic topics and methodologies, and incorporate the scarcity questions faced by every society.

The Solution

Ideally, the setting or structure of the course should make clear the connections not only among economic problems but also among economic theories developed to explain them. A truly effective structure would enable students to perceive and understand clearly the interrelationships among major topics, theories, and problems treated by economic analysis. Rather than emphasizing subdivisions of our discipline, an introductory textbook should provide students with a

unified, integrated world view, a perspective enabling them to appraise the economic nature of any problem. Upon reading or hearing of a particular news event, students should be able to say: "This topic is essentially one of (growth, allocative efficiency, equity, etc.) and concepts such as (investment, saving, comparative advantage, marginal cost, etc.) are relevant to helping me to understand and analyze it."

What I am proposing, therefore, is an introductory text that presents a comprehensive and integrated view of economic life by using a unifying theme that comes from the very essence of economics itself rather than one imposed from outside. The economic way of thinking is shown to flow from this central theme and is used repeatedly in examples and cases throughout the text to demonstrate to students that this simple but powerful approach is a *means available to them* for making sense out of the economic issues of the day.

The book begins with the central problem of economics: how should society organize itself in order to satisfy human wants with limited means? Of course, most texts should and do begin with a discussion of the fundamental problem of scarcity. This starting point for economic theory is based firmly in the real world. Unfortunately, most textbooks promptly and inexplicably shift the focus to economics *as a science* rather than continuing an examination of real economic life and its implications. It is as if Physics I focused students' attention on the nature of the science of physics rather than on the nature of the physical world! Economists are apparently just as prone as other academicians to write for one another. While such a practice is eminently appropriate in our upper level courses and graduate programs, so that young scholars may acquire the style and vocabulary of the professional, it is not appropriate for introductory forums in which we communicate with the layman for the first time.

The idea behind this book, then, is to maintain the focus on scarcity by showing how society as well as individuals can and do respond to the

not only serve as *means of explaining how societies can improve their economic well-being*, but also serve as the *analytical criteria for appraising policy*.

8. Economic growth is introduced early, in Chapter 3, because of its importance as *the primary means of raising living standards* in many nations during the past 200 years, because it provides a logical setting for introducing the concepts of saving and investment, and because it allows instructors to introduce in an integrated way current international issues such as Third World external debt, multinationals, and the brain drain.
9. Important concepts actually used by professional economists, such as “allocative efficiency,” are clearly explained in non-technical terms and reinforced by numerous illustrations for students at the introductory level.
10. Instructors have the opportunity to treat, if they wish, the alternative of reducing expectations and wants. Chapter 19 points out the unpopularity of this approach to scarcity and explores the difficulties associated with attempts to carry out this strategy as national policy.

Supplements

Accompanying this text are useful supplements to aid in the effective teaching of introductory economics. The *Study Guide*, authored by J. Eric Fredland, provides a closely-correlated companion to the text. In it, students have the opportunity of applying the text’s tools of analysis, answering short-answer essays, and testing themselves on the important ideas developed in each chapter. Students also may practice what they’ve learned by self-testing themselves with the short-answer and multiple-option test items included in the *Study Guide*.

The *Instructor’s Manual/Test Bank* is a comprehensive tool designed to assist both the novice and experienced instructor. Each chapter in the *Manual* portion contains an overview of the corresponding text chapter as well as an outline of the major topics and ideas. In addition, it provides suggestions for motivating student interest in the chapter, and shows how each chapter is related to other chapters in the text. The *Manual* portion also contains sample answers and comments on the textbook’s end-of-chapter review questions and provides the instructor with additional review questions for use in classroom discussions and on examinations. The *Test Bank* portion contains multiple-choice and true-false test items that are keyed to the material presented in each chapter. Most of the several hundred multiple-choice items have been modified as a result of their being class-tested numerous times. The *Test Bank* is available on perforated paper for cutting and pasting in preparing exams.

Transparency Masters for use with overhead projectors are available for all important Exhibits found in the text.

Acknowledgments

It is difficult to know where to begin thanking the many people who, directly or indirectly, contributed to the development of this book. First and foremost, I must express my love and gratitude to my parents, Adelchi and Carmela, for their encouragement throughout my years of schooling. Without their support, this book never would have been written. My loving wife, Barbara, because of her selflessness, was my unwavering rock of moral support during the period in which this book was nourished and brought to fruition.

My mentors at Fordham University’s Graduate School played a major role in stimulating my interests in the “human” side of economics. I will forever be in debt to Friedrich Baerwald,

problem. Thus, *economic theory is presented embedded within a framework that explores the possible options for dealing with scarcity*. I then show that there is hope for society, by presenting *the possible options* available to any society for dealing with scarcity. There are three non-mutually exclusive options which comprise the key integrating feature of the text.

The *first option* is the expansion of society's capabilities to meet human wants. Thus, economic growth is presented early in the text as a viable, historical alternative in dealing with scarcity. It is in this context that the meaning of economic cost (first introduced in Chapter 1 and used again and again throughout the book) is given its first major reinforcement. The "options for society" framework enables the topics of growth and technological change to be integrated into the overall unified scheme of the text instead of being "added on" elsewhere in the text.

The *second option* available to society is improving the way in which currently available resources are used to meet society's wants. In other words, efficiency and equity become the integrating focus of a good deal of the text. The discussion is divided into three major sections: allocative efficiency, distributional equity, and aggregate efficiency. It should be noted that the subject matter in these areas is neither new nor unique to my text. All texts have micro and macro sections, as indicated above, and most texts contain some discussion of distribution.

The *third option* consists of constraining expectations. Though this alternative is not widely accepted in the Western world, the text treatment shows how it is related to the scarcity problem. Many students are, at the very least, intrigued by alternative lifestyles, idealistic social theories, and the philosophical criticisms of materialism. Rather than convey to them, as most current texts do, that economics has nothing to say about these lively issues, one chapter in the text addresses "small is beautiful," the conservation movement, the rejection of materialism, the philosophy of Thoreau, and other related topics. I believe

that it is the responsibility of economics educators to show students how these "ethical" and "non-economic" positions relate to the scarcity problem faced by society.

Key Features of the Text

1. The unifying framework consists of the three options for dealing with scarcity, integrating the treatment of growth, changes in lifestyles, and traditional economizing concepts. The schema is comprehensive.
2. All important economic theories and analytical techniques are introduced by grounding them in a concern for the real-world problems of dealing with scarcity. Topics are *not* introduced in a shopping-list fashion.
3. The topics of efficiency and equity are part of the cohesive scheme of the text. Students are thus able to clearly see that what are typically labeled *micro*, *macro*, and *distribution* are really aspects of society's attempts at *improving how resources are utilized*.
4. Allocative and aggregate efficiency are presented as *different yet complementary* ways of dealing with scarcity. The organization of the book reveals that the two objectives are related to the broader goal of making better use of available capacity.
5. Economic goals such as growth, higher productivity, lower inflation, balanced trade, and many others are shown to be means of achieving a higher standard of living, not ends in themselves.
6. One of the most important things economic educators can impart to beginning students is a "way of thinking" that is uniquely economic. As ideas are developed, corresponding specific "tools of analysis" are identified and highlighted throughout the text.
7. Focusing primarily on allocative efficiency, equity, and aggregate efficiency provides students with a framework for evaluating public policy issues. Efficiency and equity

To The Student

This book is designed to improve your understanding of the world around you. It provides a framework that ties things together in a meaningful way. I hope you find that the organization of the book not only helps you understand current issues of the day, but also provides you with a sense of how various seemingly unconnected topics relate to one another and fit into a larger, unified view of reality.

Format

The book is structured around three major integrating themes. In order to satisfy human wants with limited means, people have three options:

1. expand resource capabilities (called economic growth);
2. improve resource use (which has three aspects: improve aggregate efficiency, allocative efficiency, and distributional equity); and
3. constrain our expectations (simplify life).

The first option is discussed in Unit A, which comprises three chapters. Chapter 1 presents some important economic concepts that are used throughout the rest of the text. Chapter 2 introduces you to the measurement of the economic performance and progress of any economy. In Chapter 3, economic growth is examined.

The second option takes up most of the book. Units B, C, and D are devoted to efficiency and equity questions as they relate to various subjects. Unit B is devoted entirely to allocative efficiency. Chapters 4 through 9 address this topic, how it is defined, measured, and evaluated. Chapters 5, 6, and 7 are very important since they provide you with a solid overview of the market system. In Chapter 8, shortcomings of the system are discussed. And in Chapter 9, we examine various policies that may be used to deal with these shortcomings.

Unit C focuses on distributional equity. Chap-

ter 10 defines the meaning of this relatively controversial term. Chapter 11 presents data on family incomes in the U.S. In Chapter 12, the workings of labor markets are examined. Finally, Chapter 13 explains private and government policies aimed at improving distributional equity.

Unit D treats the topic of aggregate efficiency. Its definition and measurement are presented in Chapter 14. Chapters 15 through 18 develop and analyze some simple economic models of the economy's aggregate performance. Chapter 18 brings you up to date concerning supply-side economics.

The third option is developed in Chapter 19, the single chapter that makes up Unit E. This concluding chapter examines the possibility of reducing our expectations and wants in order to reduce the pressures of limited resources.

This structure is intended to help you place into perspective a rich variety of topics that would otherwise appear unconnected and confusing. (Though you may not now know the meaning of many of the terms above, by the completion of your course of study you should be quite familiar with them.)

Tools of Analysis

In addition to the comprehensive framework, each chapter of the book contains "tools of analysis" that provide you with useful guidelines to analyze policy questions. Should tariffs be raised on imported automobiles? Should interstate trucking rates be deregulated further? Should wage and prices be controlled by the federal government?

You will encounter tools of analysis either preceding or following a discussion of matters to which they pertain. Sometimes they will be presented in the form of an economic rule or principle. Other times you will be given a set of key questions that you can use in examining a policy question. It is hoped that they will help you think clearly about current issues and that you will make use of them long after completing your formal study of economics.

who demonstrated the richness of the historical development of economic ideas, to John J. Klein, who taught me the artistry in economic modeling, to William Partlan, who instilled in me the necessity of focusing upon the essentials of every intellectual problem, and to Louis Spadaro, who showed me that economics is the science of asking "why." In addition, I wish to thank Ken Boulding, Paul Heyne, Robert Campbell, Robert F. McNown and Dwight R. Lee for their inspiration. Because their own textbooks were written so well and attempted to present economics as a seamless whole, they unknowingly provided me hope that the profession could continue to be moved in the direction of presenting the corpus of economics in a more cohesive framework.

I must recognize explicitly those colleagues who unselfishly gave of their time and effort to critique various parts of the manuscript: J. Eric Fredland (United States Naval Academy, Annapolis), George Tzannetakis, William Boncher, Harold Littlefield, Mary Boutilier, Dan Driscoll, among others. In addition, I would like to thank the following prepublication reviewers: William T. Baldwin, University of Kentucky; Mike Farrell, California State University, Long Beach; Robert Higgs, University of Washington; Leonard W. Martin, Cleveland State University; Kenneth D. Patterson, Oregon State University; M. Ray Perryman, Baylor University; and Don-

ald Wells, University of Arizona. Their many suggestions and criticisms made a substantial contribution towards tightening arguments, clarifying meanings, and catching factual and analytical mistakes. Nevertheless, I bear sole responsibility for any errors that may be present.

A heartfelt thanks, also, is extended to those among my many students who, over the past fifteen years, persisted in asking me "why" and "how" and "what if." I wish to thank the hundreds of my undergraduate students who class-tested the manuscript in its several versions. I am especially grateful to Valerie Iola who, as my graduate research assistant, worked conscientiously in appraising the strengths and weaknesses of each chapter of the manuscript.

Jim Boyd, editor at Scott, Foresman, is probably the person most responsible for this project. His advocacy of the merits of the approach contained herein was consistent through several versions of the manuscript.

Administrators and staff workers at the W. Paul Stillman School of Business, Seton Hall University, were very helpful in providing clerical and other support through the Economics Department and the Division of Research. In particular, I wish to acknowledge the excellent typing services provided by Joan Driver, Mary Starzynski, and Blanche Friedman.

Frank D. Tinari

Contents in Brief

Unit A Economic Foundations 2

- Chapter 1 Welcome to the World of Economics 4
- Chapter 2 Our Responses to Scarcity 22
- Chapter 3 The First Option: Expand the Capacity to Produce—National and Global Effects of Economic Growth 42

Units B, C, and D comprise the Second Option for Dealing with Scarcity: Improve the Use of Available Resources

Unit B Allocative Efficiency: The Success and Failure of Markets 72

- Chapter 4 Allocative Efficiency: National and International Implications 74
- Chapter 5 The Idea of a Market Economy 102
- Chapter 6 How Markets Tend to Work 124
- Chapter 7 Market Applications and Implications 152
- Chapter 8 Shortcomings of the Market Economy 180
- Chapter 9 Using Our Political System to Help Achieve Allocative Efficiency 207

Unit C Distributional Equity: The Success and Failure of Markets 242

- Chapter 10 What Is Distributional Equity? 244
- Chapter 11 Who's Rich? Who's Poor? 269
- Chapter 12 Market-Determined Distribution 295
- Chapter 13 What Can Society Do to Achieve Distributional Equity? 325

Unit D Aggregate Efficiency in the Market Economy 352

- Chapter 14 The Meaning and Measurement of Aggregate Efficiency 354
- Chapter 15 An Aggregate Model of the Economy 377
- Chapter 16 The Aggregate Role of Money 399
- Chapter 17 Inflation and Aggregate Efficiency 424
- Chapter 18 Policies to Achieve Aggregate Efficiency Without Inflation 449

Unit E The Psychology of Scarcity 474

- Chapter 19 The Third Option: Reduce Expectations 476

Contents

Every chapter ends with a summary and review questions.

Unit A Economic Foundations 2

1 Welcome to the World of Economics 4

1-1 The Scope of Economics 4

1-2 A Way of Thinking 5

Benefits and Costs 5

Marginal Analysis 8

Important Considerations Regarding Marginal Analysis 12

1-3 Scarcity 16

Resources 17

Manifestations of Scarcity 18

Box 1-1

Some Topics Examined by Economists 5

Box 1-2

The Economics of Going to College; Buying a House; Raising a Child 7

Box 1-3

What Is a Human Life Worth? Economics Provides a Way of Thinking About It 13

2 Our Responses to Scarcity 22

2-1 Three Options 22

Expand the Capacity to Produce 22

Improve Resource Use 23

Reduce Expectations 24

Some Comparisons 25

2-2 Measuring the Flow of Goods and Services 25

2-3 Gross National Product 28

Measurement 28

Measurement Problems 30

Mini-Summary 33

2-4 The Standard of Living: Measurement and Evaluation 34

The Value of Leisure 35

International Comparisons 35

2-5 The Population Question 36

Box 2-1
Difficulties in Making International Comparisons of Per Capita GNP 37

Box 2-2
The Peaking of America 39

3 The First Option: Expand the Capacity to Produce—National and Global Effects of Economic Growth 42

3-1 Introduction 42

3-2 Investment in Human Resources 45

Labor Force 45

Labor Force Expansion 46

Productivity 49

Human Resource Quality Improvement 50

Encouraging the Entrepreneur 52

3-3 Investment in Natural Resources 53

Increasing the Quantity of Renewable Natural Resources 53

Increasing the Quantity of Nonrenewable Natural Resources 55

Increasing the Quality of Natural Resources 57

3-4 Capital Investment 57

Expanding the Capital Stock 58

Improving the Quality of Capital 59

Substitution Among Resources 60

3-5 Important Issues Concerning Economic Growth 60

Resources Must Expand in a Coordinated Way 61

Saving Is Especially Difficult for Poor Nations 61

The International Debt “Crisis” 64

There Is No “Correct” Rate of Growth 65

The “Brain Drain” 65

Growth May Cause Cultural Problems 66

The Role of the Multinational Corporation 67

Growth Creates Pollution 67

Growth May Compete With Other Goals 68

Box 3-1
The Payoff to Investment in Education 52

Box 3-2
What Makes a Good Entrepreneur? 54

Box 3-3
Are We Running Out of Oil? 56

**Units B, C, and D comprise the Second Option for Dealing with Scarcity:
Improve the Use of Available Resources**

Unit B Allocative Efficiency: The Success and Failure of Markets 72

4 Allocative Efficiency: National and International Implications 74

4-1 The Components of Allocative Efficiency 74

Producing the Correct Mixture of Goods and Services 74

Some Fundamental Allocation Choices 76

Using the Correct Kinds and Amounts of Resources 78

4-2 Combining the Components: Taking Advantage of Resource Productivities 79

The Benefits of Specialization 79

The Benefits of Exchange 81

Mini-Summary 82

4-3 The Allocative Efficiency Role of Money 83

4-4 Practical Issues Regarding Allocative Efficiency 86

The Dynamics of Allocative Efficiency 86

Costs of Specialization 88

Equity Considerations 88

Growth and Efficiency 89

4-5 Causes of Inefficiency 90

Poorly Functioning Information Systems and Incentives 90

Restrictions on Exchange 91

Barriers to International Trade 94

4-6 Issues of International Finance 97

Foreign Exchange Rates 97

Dynamics of Exchange Rate Adjustments 97

Box 4-1

Cigarettes As Money 84

Box 4-2

Japan's Growing Comparative Advantage in Automobile Production 87

Box 4-3

Exchange in a Prisoner of War Camp 93

5 The Idea of a Market Economy 102

5-1 Prologue 102

5-2 Ways of Organizing Society 102

5-3	Markets Depend On. . .	105
	<i>Supportive Social System</i>	105
	<i>Supportive Legal System</i>	106
5-4	Buyers, Sellers, and Competition	107
5-5	Restricting the Scope of Markets	111
	<i>Harmful Effects on Others</i>	111
	<i>Morally Repugnant Market Transactions</i>	112
	<i>Mini-Summary</i>	113
5-6	Business Firms and Profits	113
	<i>Business Firms</i>	113
	<i>The Concept of Profit</i>	114
	<i>Measuring Profits</i>	117
Box 5-1		
	Adam Smith: In His Own Words	109
Box 5-2		
	The Portrayal of Entrepreneurs in TV Programs	115
Box 5-3		
	Profit By Any Other Name	119
6	How Markets Tend to Work	124
6-1	Buyers, Buyers Everywhere	124
	<i>Demand Curves</i>	126
	<i>Market Demand</i>	127
6-2	The Sellers' View	129
	<i>Market Supply</i>	131
6-3	Demand and Supply Interactions	132
6-4	Market Reactions to Changing Conditions	135
6-5	Important Aspects of Demand-Supply Analysis	138
6-6	Elasticity: How Responsive Are Buyers and Sellers?	143
	<i>Determinants of the Price Elasticity of Demand</i>	143
	<i>Price Elasticity of Demand: Some Applications</i>	145
	<i>Determinants of the Price Elasticity of Supply</i>	148
Box 6-1		
	Declining Demand Hurts "Outdoor" Museums	140
Box 6-2		
	Elasticity and a 50¢ Gasoline Tax	147

7 Market Applications and Implications 152

7-1 Connections Among Markets 152

7-2 Market Price: The Connecting Link 154

Price As Incentive 155

The Role of Relative Prices 155

7-3 The Story Behind Price Controls 158

7-4 Guaranteed Prices: Nice If You Can Get 'Em 163

7-5 Got A Problem? Subsidize or Tax It! 164

Subsidies 164

Commodity Taxes 166

Tax Incidence 167

Evaluation of Commodity Taxes 168

7-6 Consumer Boycotts 169

7-7 Allocative Efficiency Through Markets 170

Marginal Benefits and Costs—Once Again 170

Efficient Resource Use 171

Epilogue 173

Box 7-1

The Berkeley Barb Halts Publication 156

Box 7-2

Two Tragedies Due to Price Controls 161

Box 7-3

Ludwig Von Mises: In His Own Words 176

8 Shortcomings of the Market Economy 180

8-1 Competition May Not Prevail 180

Sellers Have an Interest in Trying to Reduce the Pressures of Competition 180

Barriers May Prevent the Development or Continuation of Competition 183

Contestable Markets 187

Mini-Summary 188

8-2 Costs and Benefits Are Not Completely Accounted for in Market Transactions 189

External Costs 190

Common Property 192

External Benefits 194

Mini-Summary 197

8-3 The Distributional Outcome of the Market Economy May Not Be Socially Acceptable 197

8-4	Some Debatable Criticisms	197
	<i>The Market Economy Tends to Generate Inadequate Growth</i>	198
	<i>Consumer Ignorance Makes Markets Work Inefficiently</i>	199
	<i>Market Results Are Inhumane</i>	199
	<i>Consumer Wants Are Created and Manipulated</i>	199
	<i>The Market Economy Encourages Undesirable Values</i>	200
8-5	Erroneous Criticisms of the Market	202
Box 8-1		
	The Smoking Dilemma: Do Nonsmokers Pay, Too?	191
Box 8-2		
	Our National Parks: Why Not Set Appropriate Prices?	195
9	Using Our Political System to Help Achieve Allocative Efficiency	207
9-1	Policies Reducing Barriers to Competition	208
	<i>Encourage Free Trade</i>	208
	<i>Antitrust</i>	209
	<i>Subsidies</i>	213
	<i>Removal of Government Barriers to Competition</i>	214
	<i>Mini-Summary</i>	216
9-2	When Competition Is Not Preferred	217
	<i>Regulation of Natural Monopoly</i>	217
	<i>Government Provision</i>	218
9-3	Policies Dealing With External Effects	221
	<i>Reducing External Costs</i>	221
	<i>External Benefits</i>	227
	<i>Public Goods</i>	228
	<i>Mini-Summary</i>	231
9-4	Government Finance	231
	<i>Government Uses of Funds</i>	232
	<i>Government Sources of Funds</i>	233
	<i>Government Budget Deficits</i>	236
Box 9-1		
	The Antitrust Campaign Against Bid Rigging by Road Construction Firms	211
Box 9-2		
	The FTC Loses Another Case Under Its “Shared Monopoly” Theory	212
Box 9-3		
	Public Services: How Much Do People Want Them?	229

Unit C Distributional Equity: The Success and Failure of Markets 242

10 What Is Distributional Equity? 244

- 10-1 Introduction **244**
 - The Concept of Equity* 244
 - Methods for Changing the Income Distribution* 245
 - Economic Analysis of Equity* 247
- 10-2 Distributional Systems **248**
 - Traditional Societies* 248
 - Communism* 249
 - Centrally-Controlled Economies* 252
 - The Market Economy* 252
- 10-3 Distribution Through the Market System **253**
 - Income in Accordance with Productivity* 253
 - The Equal Opportunity Condition* 253
 - The Rationing Function of Prices* 254
 - Non-Price Rationing Devices* 255
 - Mini-Summary* 257
- 10-4 Distributional Outcomes **258**
 - Equality* 258
 - Acceptable Income Differences* 259
 - Minimum Standards for All* 260
 - Some Comparisons* 261
- 10-5 The Positive Economics of Equity Achievement **262**
 - System Criteria* 262
 - Outcome Criteria* 264
 - Additional Applications* 265

Box 10-1
Voluntary Donations in America 246

Box 10-2
The Failure of Communism Among the Pilgrims 250

Box 10-3
The Old Lady and the Pope 256

Box 10-4
The Leaky-Bucket Experiment 259

11 Who's Rich? Who's Poor? 269

- 11-1 What Are We Trying to Measure? **269**
 - The Distribution of Wealth* 270
 - Wealth and Income* 274