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HOWARD SUTTON

Contemporary Economics

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For Selden and Lucy

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Preface

The Great Recession of the seventies has created a minor crisis in college economics departments. The bulky principles texts that have been widely used in the past now seem unnecessarily expensive, and many of them have failed to answer the most urgent questions behind the headlines of the last year or so: how did this inflationary recession happen? what should we do about inflation and unemployment? and how can we avoid inflationary recessions in the future? At the same time, enrollment in introductory courses has increased sharply, evidently because students are alarmed about their economic welfare and are looking for straight answers to those obvious questions.

There is clearly a need for a compact, inexpensive, up-to-date version of the standard long text, one that covers both macroeconomics and microeconomics and that can serve either as the single text for a short introductory course or as the primary text to be supplemented with other readings in a longer course. *Contemporary Economics* is designed to fill that need. It covers the topics that are essential to the principles course, and it puts special emphasis on concrete examples from recent experience.

In deciding what topics are essential, I've been guided by the three questions I mentioned earlier, and by the outlines for one-semester courses appearing in the front of many of the long texts. I've divided the material into sixteen chapters that can be grouped like this:

1. How to approach economic problems (Chapters 1–3)
2. How the economy is organized (4,5)
3. How we measure the economy's performance (6,7)

4. What causes ups and downs in production, employment, and prices (8–12)
5. How markets differ and why it's important to keep them competitive (13–15)
6. What we can do about our present problems (16)

The style of the book has evolved from a simple premise: to be genuinely useful to both students and teachers, an introductory text should be as readable as a good magazine. It should be clear, concise, and interesting, as well as accurate, thorough, and up-to-date. And a little humor here and there always helps.

I've tried to meet these standards several ways. First, I've used direct, uncomplicated English. Second, whenever possible I've drawn on recent research and examples that have been in the news. For instance, in my discussion of taxes (Chapter 5), I've summarized the findings of the major tax study by Pechman and Okner, and I've applied these findings to the income, wealth, and tax data Nelson Rockefeller submitted to Congress before he became Vice President. Third, I've introduced several new kinds of charts and diagrams to clarify some of the more difficult concepts. For example, I've used a watertank machanism to illustrate the idea of national-income equilibrium (Chapter 9). Fourth, to show how economists produce theories in response to real problems, and how these theories can lead to practical solutions, I've outlined the way John Maynard Keynes developed his General Theory and how he used the theory to change our views of the federal government's economic responsibilities (Chapters 8 and 9). Fifth, to show what we've learned (or should have learned) from our experience with recession, I've included case histories of the Great Depression and the recessions of the late fifties and midseventies. Sixth, since many key government officials, leading businessmen, and prominent economists have recently endorsed government policies that can be traced to the Monetary Theory, I've devoted an entire chapter (12) to the theory and the related evidence.

Finally, I would like to record my thanks to several people who helped me put this book together. E. Ray Canterbery and Howard Tuckman were extremely helpful in supplying ideas and pointing out many of my mistakes. (I assume responsibility for any mistakes that remain, of course.) Mervyn Adams and Allan Forsyth helped me get started on this project, and editors Jim Bergin, Herman Makler, and Miriam Klipper helped to keep me on the right track.

H.S.

Contents

1

What Economics Is About

Not too long ago, everybody talked about the economy and the weather, but nobody did anything about either. Everybody still talks about both. The difference is that we now know we can do something about one. Exactly *what* isn't always clear.

This book is about how the American economy works, and how we may be able to make it work better, which is the kind of information that can be very useful to a voter, a taxpayer, or anyone who's wondering what to do with his money.

We'll be talking about a wide variety of subjects that concern us all—inflation, unemployment, how markets work, how income and wealth are distributed, and how business and government fit into the economic scheme of things. We'll look at some of the larger problems and some of the solutions economists have proposed. And since some of these solutions conflict, we'll try to lay out the facts so you can make your own decision about which solution is best in any particular case.

What is economics, anyway? Economics is about how people—individuals, companies, countries—handle the problem of scarcity. Almost everything worth anything is scarce. Since people are rarely satisfied with what they have, and since they never have enough resources (land, labor, capital) to provide everything they could possibly want, they have to keep making decisions about what to do with what they've got. Economics is concerned with the way these decisions are made. *So, economics is the study of how people organize their limited resources to get the products and services they want.*

The scientific approach

Economics is a science, a systematic way of collecting and arranging facts in order to figure out how things work. It's a *social* science—as opposed to a *natural* or a *physical* science like biology or physics—because it's concerned with how *people,* rather than amoebas or atoms, behave.

To study this behavior, economists use what's called *the scientific method.* A few centuries ago, English philosopher Francis Bacon described this method as a four-step process: observation, measurement, explanation, and verification. Today, the process is usually expanded into something like this:

1. *Problem definition:* What question are you trying to answer?
2. *Hypothesis:* Make a guess about what you expect to find.
3. *Measurement:* Get the facts.
4. *Hypothesis confirmation:* See whether the facts support your original guess.
5. *Verification:* Check your procedures and the facts.
6. *Conclusion:* Formulate a general rule that can be used for making predictions about similar cases.

We'll come back to this sequence in a minute, but first, let's acknowledge that studying human behavior can be tricky. It's not like studying constellations, crustaceans, or spermatazoa, whose behavior tends to be consistent. Humans are much more erratic. Their patterns of behavior continually change, so it's hard to get nice, neat measurements. Although this may complicate the results of economic research, it doesn't necessarily make economics any less scientific than the physical sciences.

What matters is that economists pursue the scientific method—that they take great care to measure and describe what they are studying as accurately as possible and that they follow the rules of logic (see Table 1–1).

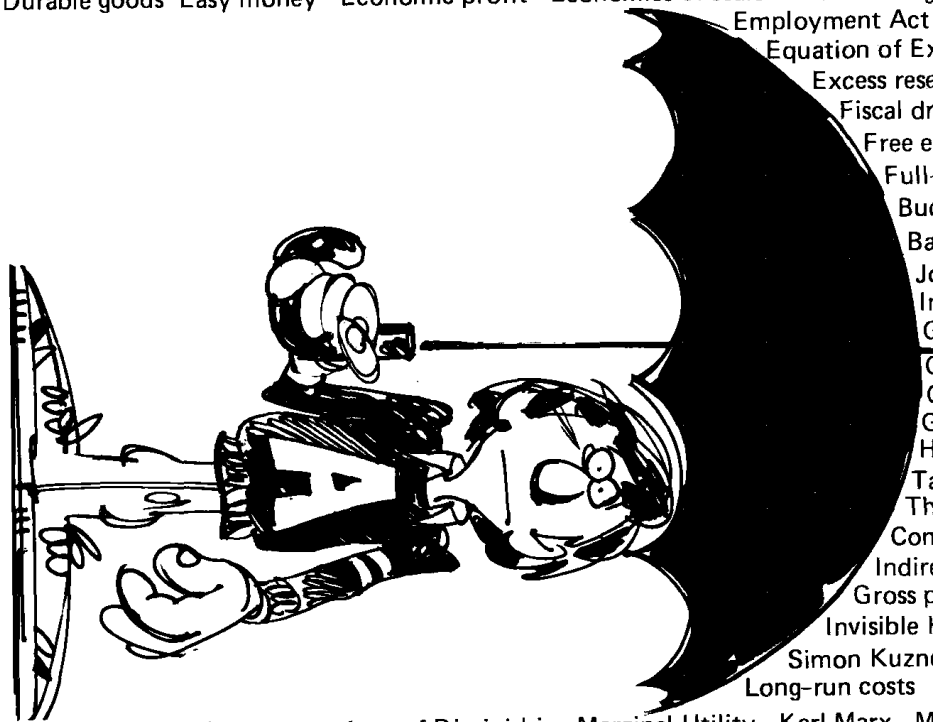
Of course, using the scientific method can lead to a lot of hedging, an endless shuttle between "on one hand" and "on the other hand." We'll try to keep our discussions scientific without loading them down with lots of qualifications, technicalities, footnotes, and such.

So let's proceed, with this one word of warning: we'll be looking at the tip of the iceberg; there's much more to almost every topic we'll mention—but nothing that would invalidate the essential points we'll cover.

Positive versus normative economics

It's useful to make a distinction between *positive economics* and *normative economics.* Positive economics deals only with facts—what has happened, what is happening. Normative economics deals with facts plus value judgments—what things *should* be like.

Ability-to-pay principle Aggregate demand Automatic stabilizers Average propensity to consume
Breakeven point Capital consumption allowance Circular Flow Classical Theory Collusion
Constant dollars Consumer sovereignty Cost-push inflation Current dollars Business cycles Tax deduction
Managed demand Law of Demand Demand deposit Demand-pull inflation Deposit multiplier
Law of Diminishing Returns Discount rate Diseconomies of scale Disposable Personal Income Dissaving
Durable goods Easy money Economic profit Economies of scale Economizing Elasticity of demand



Employment Act of 1946 Entrepreneur
Equation of Exchange Equilibrium price
Excess reserves Federal Reserve System
Fiscal drag Fiscal policy Fixed costs
Free enterprise Milton Friedman
Full-employment budget
Budget deficit Functional finance
Balanced budget Budget surplus
John Kenneth Galbraith
Implicit GNP deflator
Gold exchange standard
Government Purchases
Gross National Product
Guaranteed annual income
Hyperinflation Pure competition
Tax incidence Income distribution
The General Theory Income taxes
Consumer Price Index Interest rate
Indirect business taxes Inflationary gap
Gross private domestic investment
Invisible Hand John Maynard Keynes
Simon Kuznets Labor force Laissez-faire
Long-run costs Macroeconomics Thomas Malthus
Marginal propensity to save Law of Diminishing Marginal Utility Karl Marx MC = MR Rule Member banks
Microeconomics John Stuart Mill Minimum wage Mixed capitalism Monetary policy Monetary Theory
Money M_1 Monetary Rule Money supply Monopolistic competition Monopoly Price leader Multiplier Effect
Municipal bonds Net National Product Nonprice competition Normative economics Normal profit Oligopoly
Open-market operations Opportunity cost Fiat money Paradox of Thrift Partnership Corporation
Proprietorship Phillips curve Positive economics Poverty Price ceilings Wage-price controls Private sector

Table 1–1: FIVE COMMON FALLACIES

1. *The Expert-Opinion Trap*
   "It must be true—nine out of ten Ph.Ds agree."
   Even experts make mistakes. In fact, almost all of the really magnificent mistakes are made by experts. Don't be misled by credentials; judge the statement itself.

2. *The Majority-Opinion Trap*
   "Well, if 150 million Americans think so, who am I to disagree?"
   Truth is never decided by majority opinion. If it were, the earth would be flat. Don't be conned by the crowd.

3. *The Prejudice Trap*
   "It must be true. Brutus said so, and he's an honorable man."
   Who made the statement has nothing to do with whether or not it's true. Don't be misled by your bias for or against the source.

4. *The Part-and-Whole Trap*
   "For years I [have] thought what was good for our country was good for General Motors, and vice versa." (Charles Wilson's immortal statement. At the time, he was president of G.M. and soon to be head of the Defense Department.)
   The effect on the whole isn't necessarily the same as the effect on a part of the whole. A special tax on imported cars might be good for General Motors but not necessarily for the country as a whole, since G.M. would be under less pressure to keep their prices down. Even if we suppose that such a tax could be good for the country as a whole, there's at least one part of the whole that wouldn't benefit—the people who want to buy Volkswagens or Jaguars.

5. *The Cause-and-Effect Trap*
   "In Sweden, taxes amount to about 40 percent of the gross national product, compared with about 30 percent in the United States. The countries' suicide rates are 161 and 101 per 100,000 population, respectively. Therefore, high taxes must be a cause of suicide."
   Tax rates and suicide rates are "correlated" here, but we can't assume a cause-and-effect relation between them. There could be any number of alternative explanations for Sweden's higher suicide rate. Maybe they compute their rate differently. Maybe it's those long cold winters.

Or try it this way: positive economics tells it like it is (or was), normative economics tells it like it ought to be. *Is* versus *ought.*

Let's take a couple of examples. First a positive statement: everyone who wants a job has one. This is a matter of fact; it may or may not be true. A normative statement on the same subject might go like this: everyone who wants a job ought to have one.

Or take this statement: high-income families—those with annual incomes of, say, $50,000 or more—pay a higher percentage for federal income tax than lower-income families do. The statement is positive because it's a matter of truth, which we can check out by looking up the statistics the federal government provides.

Here is a normative version of the same proposition: It's not fair for these high-income families ($50,000 or more) to have to pay a higher percentage for federal income tax. There's no question about the facts in this case; it's a matter of value, of justice, of politics. We can argue about it, but there's no way to *prove* the system is or isn't fair.

Positive versus normative: is versus ought.

Costs

In economics, almost everything has a cost. Ordinarily, we'll be converting costs into dollar equivalents, if at all possible, because this provides a common denominator for resources, products, and services, and because numbers are easier to analyze and argue about.

This emphasis on dollar costs, or prices, may seem a little cynical. ("What is a cynic? A man who knows the price of everything and the value of nothing."—Oscar Wilde) It's important to recognize, though, that this cost-oriented analysis is justified whether we're talking about positive matters or normative matters. No matter how worthy a project may be—from providing free rock concerts to wiping out poverty—it makes sense to estimate the costs before doing anything else. You have to tell it like it is before you can decide what to do about it.

Theories, models, and reality

Reality, like the abominable snowman, can be very elusive. Economists have been trying to describe this strange Thing (reality, that is) for a couple of hundred years. Apparently they're getting better at it, partly because they have better machinery for collecting the facts, and partly because they've come up with more sophisticated ways of generalizing about the reality behind the facts.

For years, a scientist's generalizations about facts have been called *theo-*

ries, but *model* is increasingly used as a synonym for theory. A model is a simplified representation of a real situation—the workings of the stock market, for example, or a country's banking system. Although the word itself implies something tangible, like a ship model, it's important to understand that economic models are abstractions—sets of ideas. They can be *expressed* in the form of words, graphs, tables of numbers, mathematical equations, cartoons, and maybe even music, but the models shouldn't be confused with the forms in which they're communicated. Nor should they be confused with the real situations they represent. At best, models are only rough approximations of reality. A model may be expressed clearly or cleverly or intricately, but the crucial test is this: how accurately does it describe a real situation?

How do you test a model? Ideally, you set up a repeatable experiment that will prove or disprove the basic propositions. Let's borrow an example from physics.

Testing a model by experiment. In the sixteenth century, Galileo, a dropout from the University of Pisa, caused a lot of controversy by questioning the established theories of gravity. The conventional model assumed that heavy bodies fall with speeds proportional to their weights—fat men fall faster than thin men. But Galileo's model assumed that weight has nothing to do with the speed. To test these conflicting models, he devised an experiment that any skeptic could duplicate. With his flair for the dramatic, he invited a group of professors and students to watch him drop a few heavy objects along with some light ones from the top of the Leaning Tower. Of course, all the objects hit the ground at the same time.

Now, Galileo may not have gone through exactly the same steps we listed earlier, but it's clear that he was employing the scientific method. Here, with an anachronism or two, is how he might have checked out his model:

> *Problem definition.* The people at Pisa University are convinced that a heavy object will always fall faster than a light one. I think they're wrong. Let's settle it once and for all. The question is, does weight have any effect on falling speed?
>
> *Hypothesis.* I have a hunch that if I dropped something light and something much heavier from a high place, they'd hit the ground at exactly the same time. I'd like to try the Tower, but it looks like it's about to fall over any minute now. . . . Anyhow, let's try it.
>
> *Measurement.* Laaaaadies and gentlemen! I am about to offer an ocular demonstration of the falsehood of the ancient dictum that heavy bodies fall with velocities proportional to their weights. You'll notice that I have here a cannonball and a small salami—a heavy object and a light object. I'll drop both objects at exactly the same time, and you will see with your own eyes whether one object has preceded the other. (*Drops both objects.*)

Hypothesis confirmation. I think everyone will agree that the two objects struck the ground at the same time. (*Students cheer; professors grumble.*)

Verification. Now, ladies and gentlemen, to verify the results of this experiment, I've asked His Honor, the Mayor, to repeat the entire procedure. . . . Whenever you're ready, Your Honor. I'd suggest you use a different salami. (*Drops both objects. More cheers, grumbles.*)

Conclusion. And so, my fellow Pisans, we arrive at this conclusion: the weight of an object has absolutely no effect on its falling speed.

Thank you, and good afternoon.

Approximating the experimental situation. Economists seldom have the luxury of repeatable experiments like this. The trouble is that the economic environment is never exactly the same. People change, products change, and so do the ways products are made and distributed. Anyone can repeat Galileo's experiment today, some four hundred years later, and arrive at the same conclusion about gravity. But an economist can make only crude parallels between the present and the past. And he can make only very general inferences about the causes and effects of economic events. This means that, to test his models, the economist usually has to be content with demonstration rather than proof—demonstration by reason, analysis, and illustration.

Although economists don't have much chance to conduct experiments, they can use other kinds of information to at least approximate the experimental situation. For example, A. W. Phillips used government statistics to work out a theory of inflation and employment. His model is usually expressed in the form of a device known, fittingly enough, as a Phillips curve. We'll look at several Phillips curves later on. At this point, it may be worth reviewing the steps he might have gone through (again, the example is purely imaginary):

Problem definition. Is there any consistent relation between inflation and unemployment?

Hypothesis. My guess is that the inflation rate usually goes up when the unemployment rate goes down. And vice versa.

Measurement. The government has been measuring unemployment and inflation for years. Let's dig up the figures for a ten-year period—say, the years from 1960 through 1969. Then we can chart them out and see if there's any kind of pattern. *[Take a look at Table 1–2 and Figure 1–1. We'll talk about how they're connected later.]*

Hypothesis confirmation. By George, the points seem to form a pretty smooth line, which means the relation is consistent. And as I suspected, the rates are inversely related—one rate increases when the other decreases.

Verification. Now let's chart out the figures for several other ten-year periods to see whether we get similar curves. *[Let's assume*