

1998 UPDATE

ECONOMICS

PRINCIPLES AND POLICY

SEVENTH
EDITION



WILLIAM J. BAUMOL

ALAN S. BLINDER

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WILLIAM J. BAUMOL

C.V. STARR CENTER FOR

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ALAN S. BLINDER

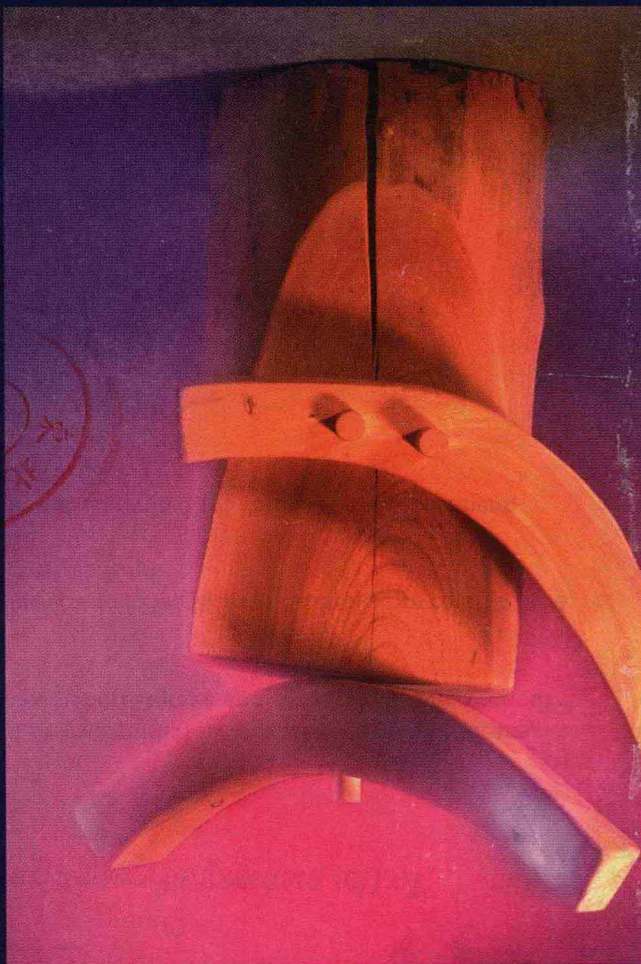
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To my four children, Ellen, Daniel, and now Sabrina and Jim

W.J.B.

To the memory of my father, Morris Blinder, to whom I owe much

A.S.B.

■ PREFACE

The Seventh Edition continues the basic philosophy of its predecessors. In particular, we avoid the fiction, so popular among textbook writers, that everything is of the utmost importance—a pretense that students are sufficiently intelligent to see through in any event. We try, instead, to highlight those important ideas that are likely to be of lasting significance—principles that students will want to remember long after the course is over because they offer insights that are far from obvious, because they are of practical importance, and because they are widely misunderstood by intelligent laymen. A dozen of the most important of these ideas are selected as **Ideas for Beyond the Final Exam** and are called to the reader's attention when they occur through the use of the symbol .

While all modern economics textbooks abound with “real world” examples, we try to go beyond this by elevating the examples to preeminence. In our view, the policy issue or everyday economic problem ought to lead the student naturally to the economic principle, not the other way around. For this reason, almost every chapter begins with a real policy issue or a practical problem that may seem puzzling or paradoxical to noneconomists. We then proceed to describe the economic analysis required to remove the mystery.

In so doing, we use technical terminology and diagrams only where there is a clear need for them, never for their own sake. Still, economics is a technical subject, and so this is, unavoidably, a book for the desk and not for the bed. We make, however, strenuous efforts to simplify the technical level of the discussion as much as possible without sacrificing content. Fortunately, almost every important idea in economics can be explained in plain English, and this is what we try to do.

Each edition of this book has been influenced by economic events. Reflecting the growing “globalization” of the world economy, the Fifth Edition was substantially revised to exhibit more clearly the international linkages between the U.S. economy and other economies. The Sixth Edition was written just after the collapse of communism. Since the book has long focused on the market mechanism and how it works, it was easy to incorporate these stunning events into the discussion. Both of these features are retained in the Seventh Edition.

But the Seventh Edition is also affected by another critical development—one that cannot be dealt with so definitively: rising inequality in the world's industrialized countries in general, and in the United States in particular. While overall income continues to grow in these countries, more and more of each nation's income and wealth are going to the most affluent portion of the population, while lower-income groups fall further and further behind. This development is not new; it has been going on for more than a decade. But its very persistence has now made it a subject of urgent concern.

Rising inequality has been accompanied by a sharp and continuing slowdown of growth and by a severe stagnation in the rise of American real wages. Unfortunately, no one is quite sure about the causes of these worrisome developments

nor about the means that can be used to ameliorate them. The issues are, therefore, raised at a number of points in this book, and the pertinent facts are reported and discussed. But we are suitably modest in discussing both the underlying causes and the policy issues to which they give rise.

Several new features of this edition are worth noting. The order of the core chapters on microeconomics, Chapters 5 through 8, has been changed in response to suggestions from readers. Their suggestions also led us to add more substantial discussions of consumers' surplus in Chapter 5, price discrimination in Chapter 11, and game theory in Chapter 12. Many more "Policy Debate" boxes, a popular feature of the last edition, have been added to this edition. We have also included a new feature that offers students a somewhat more tangible picture of some of the subjects discussed. New boxes called "You Are There" describe a meeting of the Federal Open Market Committee, an antitrust court case, and activities on the floor of the New York Stock Exchange. Finally, the book has undergone extensive and painstaking updating throughout, so that new material could be added without increasing overall length.

As a last personal note, we must mention that most of the Seventh Edition, like the Sixth before it, had to be written under the handicap of a separation between the coauthors. Happily, this separation entailed neither disagreement nor rancor, and is now over. Alan Blinder's sojourn in Washington—first as a member of the President's Council of Economic Advisers and then as Vice Chairman of the Federal Reserve Board—has undoubtedly contributed to the relevance of this book's materials to the real world. But it has also made communication between us far more challenging.

However, there is a silver lining to this cloud of inconvenience. Blinder reports renewed and enhanced respect for Herbert Stein's sage observation that "most of the economics that is usable for advising on public policy is at about the level of the introductory undergraduate course."

NOTE TO THE STUDENT

We would like to offer one suggestion for success in your economics course. Unlike some of the other courses you may be taking, economics is cumulative—each week's lesson builds upon what you have learned before. You will save yourself both a lot of frustration and a lot of work by keeping up on a week-to-week basis. To assist you in doing so, a chapter summary, a list of important terms and concepts, and a selection of questions to help you with your review are provided at the end of each chapter. Making use of these learning aids will increase your success in your economics course. For additional assistance, see the following list of ancillary materials.

ANCILLARIES

As economic education incorporates new technologies, our extensive learning package has been expanded and improved to accommodate the needs of students and instructors.

- *Study Guide* by Craig Swan, University of Minnesota (for students). Our study guide, which is available in micro and macro split versions, includes learning objectives, a list of important terms and concepts for every chapter, and a quiz that helps students test their understanding and comprehension of concepts. Also included are multiple-choice tests for self-understanding, a list of supplementary readings and study questions for every chapter, and "Economics

in Action” sections that use current news articles to illustrate economic concepts. A new feature, “Economics On-Line,” outlines useful Internet and Web sources for economic data and information. Periodic updates of these sources will be provided on the Dryden/Harcourt Web page: www.hbcollege.com.

- *Instructor’s Manual/Transparency Masters* by John Isbister, University of California—Santa Cruz. Every chapter in the revised *Instructor’s Manual* consists of detailed chapter outlines, teaching tips and suggestions, answers to review questions in the text, and questions for classroom discussion. Multiple-choice questions suitable for quizzes and tests have been added in this edition. The transparency masters include all figures and tables not available as acetates.
- *Microeconomics Test Bank* by Colleen Cameron, University of Mississippi. This updated and reorganized test bank, which consists of more than 5,500 questions, covers Chapters 1–21 and Chapter 34 in the text. Every question has been checked to ensure the accuracy and clarity of the answers, and special thanks go to Bryan Taylor for providing this important service. The questions include true/false, analytical and definitional, multiple-choice, and critical-thinking, short-answer questions. Questions have been organized by section in the text to help instructors pick and choose questions with minimum inconvenience. The test bank is also available in computerized IBM and Windows versions in our easy-to-use *EXAMaster* program. *EXAMaster* allows you to add and edit your own questions, create and edit graphics, print scrambled versions of tests, convert multiple-choice questions to open-ended questions, plus much more.
- *Macroeconomics Test Bank* by John Dodge, University of Sioux Falls. This updated test bank covers Chapters 1–4 and 22–38 in the text. Consisting of more than 5,000 questions, the test bank helps students understand and comprehend the book’s concepts and their applicability to real-world situations. Every question has been checked to ensure the accuracy and clarity of the answers, and we thank Ivan Weinel for assisting with this important task. The true/false, multiple-choice, and short-answer questions, which are organized by section in the text, encourage critical thinking and analytical skills. The test bank is also available in computerized IBM and Windows versions in the *EXAMaster* program.
- *Transparency Acetates*. Full color transparency acetates for all important figures and tables in the text are available in micro and macro split versions.
- *Weekly News Updates*. Each news update links topics in the text with current economic events and consists of the synopsis of a pertinent article, references to a topic or chapter in the text, and a few discussion questions suitable for classroom use. The news updates are posted on the Harcourt Web page.
- *PowerPoint® Presentation Software*. This user-friendly slide show is suitable for classroom presentations. It consists of important graphs and tables from the text as well as bulleted summaries and chapter outlines. *PowerPoint Viewer* is provided in the package.
- *Tutorial, Analytical, and Graphing (TAG) Software* by Todd Porter and Teresa Riley, Youngstown State University (for students). In addition to an extensive chapter-by-chapter tutorial, a hands-on graphing section in which students are actually required to draw curves (with keystrokes or a mouse), and a practice exam for each section, this tutorial software consists of a number of new and innovative features added for this edition. Annotated multiple-choice questions give students feedback on their answers and explain reasons

why a particular answer is right or wrong. The software is now available in a new Windows version.

The Dryden Press may provide complimentary instructional aids and supplements or supplement packages to those adopters qualified under its adoption policy. Please contact your sales representative for more information. If as an adopter or potential user you receive supplements you do not need, please return them to your sales representative or send them to: Attn: Returns Department, Troy Warehouse, 465 South Lincoln Drive, Troy, MO 63379.

NOTE TO THE INSTRUCTOR

In trying to improve the book from one edition to the next, we rely heavily on our experiences as teachers. But our experience using the book is minuscule compared with that of the hundreds of instructors who use it nationwide. If you encounter problems, or have suggestions for improving the book, we urge you to let us know by writing to either one of us in care of The Dryden Press, 301 Commerce Street, Suite 3700, Fort Worth, TX 76102. Such letters are invaluable, and we are glad to receive them, even if they are critical (but not *too* critical!). Many such suggestions accumulated over the past three years found their way into the Seventh Edition. What follows are suggested course outlines for both one-semester and one-quarter courses.

OUTLINE FOR A ONE-SEMESTER COURSE IN MICROECONOMICS

Chapter Number	Title
1	What Is Economics?
2	The U.S. Economy: Myth and Reality
3	Scarcity and Choice: <i>The Economic Problem</i>
4	Supply and Demand: An Initial Look
5	Consumer Choice: The Demand Side of the Market
6	Demand and Elasticity
7	Production, Inputs, and Cost: Building Blocks for Supply Analysis
8	Output, Price, and Profit: The Importance of Marginal Analysis
9	The Firm and the Industry under Perfect Competition
10	The Price System and the Case for Laissez-Faire
11	Monopoly
12	Between Competition and Monopoly
13	The Market Mechanism: Shortcomings and Remedies
14	Real Firms and Their Financing: Stocks and Bonds
15	Pricing the Factors of Production
16	Labor: The Human Input
18	Limiting Market Power: Regulation of Industry
19	Limiting Market Power: Antitrust Policy
20	Taxation and Resource Allocation

Plus any two of the following:

- | | |
|----|--|
| 17 | Poverty, Inequality, and Discrimination |
| 21 | Environmental Protection and Resource Conservation: The Economist's Approach |
| 34 | International Trade and Comparative Advantage |
| 38 | Comparative Economic Systems: What Are the Choices? |

OUTLINE FOR A ONE-SEMESTER COURSE IN MACROECONOMICS

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23	Unemployment and Inflation: The Twin Evils of Macroeconomics
24	Income and Spending: The Powerful Consumer
25	Demand-Side Equilibrium: Unemployment or Inflation?
26	Changes on the Demand Side: Multiplier Analysis
27	Supply-Side Equilibrium: Unemployment <i>and</i> Inflation?
28	Managing Aggregate Demand: Fiscal Policy
29	Money and the Banking System
30	Monetary Policy and the National Economy
31	The Debate over Monetary Policy
32	Budget Deficits and the National Debt: Fact and Fiction
33	The Trade-off between Inflation and Unemployment
34	International Trade and Comparative Advantage
35	The International Monetary System: Order or Disorder?
36	Macroeconomics in a World Economy
37	Productivity and Growth in the Wealth of Nations
38	Comparative Economic Systems: What Are the Choices?

OUTLINE FOR A ONE-SEMESTER COURSE COVERING BOTH MACROECONOMICS AND MICROECONOMICS

Chapter Number	Title
1	What Is Economics?
2	The U.S. Economy: Myth and Reality
3	Scarcity and Choice: <i>The Economic Problem</i>
4	Supply and Demand: An Initial Look
5	Consumer Choice: The Demand Side of the Market
6	Demand and Elasticity
7	Production, Inputs, and Cost: Building Blocks for Supply Analysis
8	Output, Price, and Profit: The Importance of Marginal Analysis
11	Monopoly
12	Between Competition and Monopoly
15	Pricing the Factors of Production
16	Labor: The Human Input
22	The Realm of Macroeconomics
24	Income and Spending: The Powerful Consumer
25	Demand-Side Equilibrium: Unemployment or Inflation?
27	Supply-Side Equilibrium: Unemployment <i>and</i> Inflation?

OUTLINE FOR A ONE-QUARTER COURSE IN MICROECONOMICS

Chapter Number	Title
3	Scarcity and Choice: <i>The Economic Problem</i>
4	Supply and Demand: An Initial Look

5	Consumer Choice: The Demand Side of the Market
6	Demand and Elasticity
7	Production, Inputs, and Cost: Building Blocks for Supply Analysis
8	Output, Price, and Profit: The Importance of Marginal Analysis
9	The Firm and the Industry under Perfect Competition
10	The Price System and the Case for Laissez-Faire
11	Monopoly
12	Between Competition and Monopoly
13	The Market Mechanism: Shortcomings and Remedies
14	Real Firms and Their Financing: Stocks and Bonds
15	Pricing the Factors of Production
16	Labor: The Human Input
20	Taxation and Resource Allocation

OUTLINE FOR A ONE-QUARTER COURSE IN MACROECONOMICS

Chapter Number	Title
1	What Is Economics?
2	The U.S. Economy: Myth and Reality
3	Scarcity and Choice: <i>The Economic Problem</i>
4	Supply and Demand: An Initial Look
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23	Unemployment and Inflation: The Twin Evils of Macroeconomics
24	Income and Spending: The Powerful Consumer
25	Demand-Side Equilibrium: Unemployment or Inflation?
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29	Money and the Banking System
30	Monetary Policy and the National Economy
31	The Debate over Monetary Policy
32	Budget Deficits and the National Debt: Fact and Fiction
33	The Trade-off between Inflation and Unemployment

OUTLINE FOR A ONE-QUARTER COURSE ON APPLICATIONS OF BOTH MACROECONOMICS AND MICROECONOMICS

Chapter Number	Title
17	Poverty, Inequality, and Discrimination
18	Limiting Market Power: Regulation of Industry
19	Limiting Market Power: Antitrust Policy
20	Taxation and Resource Allocation
21	Environmental Protection and Resource Conservation: The Economist's Approach
23	Unemployment and Inflation: The Twin Evils of Macroeconomics
32	Budget Deficits and the National Debt: Fact and Fiction
34	International Trade and Comparative Advantage
35	The International Monetary System: Order or Disorder?
37	Productivity and Growth in the Wealth of Nations
38	Comparative Economic Systems: What Are the Choices?

WITH THANKS

Finally, and with great pleasure, we turn to the customary acknowledgments of indebtedness. Ours have been accumulating now through seven editions. In these days of specialization, not even a pair of authors can master every subject that an introductory textbook must cover. Our friends and colleagues Albert Ando, Charles Berry, Rebecca Blank, William Branson, the late Lester Chandler, Gregory Chow, Avinash Dixit, Robert Eisner, Susan Feiner, the late Stephen Goldfeld, Claudia Goldin, Ronald Grieson, Daniel Hamermesh, Yuzo Honda, Peter Kenen, Melvin Krauss, Herbert Levine, the late Arthur Lewis, Burton Malkiel, Edwin Mills, Janusz Ordover, Uwe Reinhardt, Harvey Rosen, Laura Tyson, and Martin Weitzman have all given generously of their knowledge in particular areas over the course of seven editions. We have learned much from them, and only wish we had learned more.

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Obviously, the book you hold in your hand was not produced by us alone. An essential role was played by the fine people at The Dryden Press, including Emily Barrosse, Executive Editor for Economics; Jeanie Anirudhan, Developmental Editor; Stacey Sims, Developmental Editor; Amy Schmidt, Project Editor; Linda Miller, Art Director; and Ann Coburn, Production Manager. We would also like to thank Carol Cirulli and Sean Latham for their role in this edition. We appreciate all of their efforts. William Baumol is grateful to the publisher, and especially to Linda Miller, the book's art director, for the decision to use photographs of Professor Baumol's sculptures as a design feature.

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And, finally, there are our wives, Hilda Baumol and Madeline Blinder. They have now participated and helped with this project for over 20 years. During that period, this book has quite literally become part of our families. And both their contributions and our affection have grown.

WILLIAM J. BAUMOL
ALAN S. BLINDER

■ BRIEF CONTENTS

Preface v

PART I

GETTING ACQUAINTED WITH ECONOMICS 1

- 1 What Is Economics? 3
- 2 The U.S. Economy: Myth and Reality 25
- 3 Scarcity and Choice: *The Economic Problem* 49
- 4 Supply and Demand: An Initial Look 67

PART II

ESSENTIALS OF MICROECONOMICS: CONSUMERS AND FIRMS 93

- 5 Consumer Choice: The Demand Side of the Market 95
- 6 Demand and Elasticity 125
- 7 Production, Inputs, and Cost: Building Blocks for Supply Analysis 147
- 8 Output, Price, and Profit: The Importance of Marginal Analysis 181

PART III

THE MARKET SYSTEM: VIRTUES AND VICES 207

- 9 The Firm and the Industry under Perfect Competition 209
- 10 The Price System and the Case for Laissez-Faire 233
- 11 Monopoly 255
- 12 Between Competition and Monopoly 275
- 13 The Market Mechanism: Shortcomings and Remedies 301
- 14 Real Firms and Their Financing: Stocks and Bonds 325

PART IV

THE DISTRIBUTION OF INCOME 349

- 15 Pricing the Factors of Production 351
- 16 Labor: The Human Input 377
- 17 Poverty, Inequality, and Discrimination 403

PART V

THE GOVERNMENT AND THE ECONOMY 429

- 18 Limiting Market Power: Regulation of Industry 431
- 19 Limiting Market Power: Antitrust Policy 451
- 20 Taxation and Resource Allocation 469
- 21 Environmental Protection and Resource Conservation: The Economist's Approach 491

PART VI

THE MACROECONOMY: AGGREGATE SUPPLY AND DEMAND 515

- 22 The Realm of Macroeconomics 517
- 23 Unemployment and Inflation: The Twin Evils of Macroeconomics 537
- 24 Income and Spending: The Powerful Consumer 563
- 25 Demand-Side Equilibrium: Unemployment or Inflation? 587

- 26 Changes on the Demand Side: Multiplier Analysis 609
- 27 Supply-Side Equilibrium: Unemployment *and* Inflation? 627

PART VII

FISCAL AND MONETARY POLICY 647

- 28 Managing Aggregate Demand: Fiscal Policy 649
- 29 Money and the Banking System 671
- 30 Monetary Policy and the National Economy 695
- 31 The Debate over Monetary Policy 717
- 32 Budget Deficits and the National Debt: Fact and Fiction 745
- 33 The Trade-off between Inflation and Unemployment 769

PART VIII

THE UNITED STATES IN THE WORLD ECONOMY 795

- 34 International Trade and Comparative Advantage 797
- 35 The International Monetary System: Order or Disorder? 821
- 36 Macroeconomics in a World Economy 845
- 37 Productivity and Growth in the Wealth of Nations 865
- 38 Comparative Economic Systems: What Are the Choices? 897

Glossary G-1

Credits C-1

Index I-1

■ ABOUT THE AUTHORS

William J. Baumol was born and raised in New York City. He received his undergraduate degree in economics with a minor in art from the City University of New York and his Ph.D. in economics from the London School of Economics.

He taught at Princeton University for over forty years, and he is now at New York University, where he is the director of the C.V. Starr Center for Applied Economics.

Professor Baumol has published over five hundred scholarly articles and more than twenty books that have been translated into a dozen languages.

He has been president of four professional societies, including the American Economic Association. He is also a member of the Board of Trustees of the Joint Council on Economic Education and a member of the National Academy of Sciences.

He is married and has two children and two grandchildren. In addition to courses in economics, Professor Baumol also taught wood sculpture at Princeton University.

Alan S. Blinder was born in New York City and earned his A.B. at Princeton University, his M.Sc. at the London School of Economics, and his Ph.D. at Massachusetts Institute of Technology—all in economics.

Since 1971, he has taught at Princeton University, where he is now the Gordon S. Rentschler Memorial Professor of Economics. Professor Blinder chaired the department of economics from 1988 to 1990, and he is also the founder and director of Princeton's Center for Economic Policy Studies.

Professor Blinder is the author of ten books and scores of scholarly articles. He is a member of the American Philosophical Society and the American Academy of Arts and Sciences. From January 1993 through January 1996, he served in Washington—first as a member of the President's Council of Economic Advisers and then as Vice Chairman of the Board of Governors of the Federal Reserve System.

Professor Blinder is married, has two sons, and resides in Princeton, New Jersey.

■ CONTENTS

Preface v

PART I

GETTING ACQUAINTED WITH ECONOMICS 1

CHAPTER 1 WHAT IS ECONOMICS? 3

Ideas for Beyond the Final Exam 3

- Idea 1: Mutual Gains from Voluntary Exchange 4
- Idea 2: Rational Choice and True Economic Costs: The Role of Opportunity Cost 4
- Idea 3: Attempts to Repeal the Laws of Supply and Demand: The Market Strikes Back 5
- Idea 4: The Importance of Marginal Analysis 5
- Idea 5: Externalities: A Shortcoming of the Market Cured by Market Methods 6
- Idea 6: The Cost Disease of the Personal Services 6
- Idea 7: The Trade-off between Output and Equality 7
- Idea 8: The Trade-off between Inflation and Unemployment 7
- Idea 9: The Illusion of High Interest Rates 8
- Idea 10: Do Budget Deficits Burden Future Generations? 8
- Idea 11: The Overwhelming Importance of Productivity Growth in the Long Run 9
- Idea 12: The Surprising Principle of Comparative Advantage 9

Inside the Economist's Tool Kit 10

Economics as a Discipline 10

The Need for Abstraction 10

The Role of Economic Theory 13

What Is an Economic "Model"? 15

Reasons for Disagreements: Imperfect Information and Value Judgments 16

Last Word: Common Sense Is Not Always Reliable 17

Summary 17

Key Terms 17

Questions for Review 18

Appendix: The Graphs Used in Economic Analysis 18

Two-Variable Diagrams 18

The Definition and Measurement of Slope 19

Rays through the Origin and 45° Lines 22

Squeezing Three Dimensions into Two: Contour Maps 23

Summary 24

Key Terms 24

Questions for Review 24

Supply and the Quantity Supplied	71
Equilibrium of Supply and Demand	73
Shifts of the Demand Curve	75
Shifts of the Supply Curve	79
Restraining the Market Mechanism: Price Ceilings	83
<i>Policy Debate: Economic Aspects of the War on Drugs</i>	<i>84</i>
Restraining the Market Mechanism: Price Floors	86
A Can of Worms	87
A Simple but Powerful Lesson	89
Summary	89
Key Terms	90
Questions for Review	90

PART II

ESSENTIALS OF MICROECONOMICS: CONSUMERS AND FIRMS 93

CHAPTER 5 CONSUMER CHOICE: THE DEMAND SIDE OF THE MARKET 95

A Paradox: Should Water Be Worth More Than Diamonds?	96
Scarcity and Demand	96
Total and Marginal Utility	97
<i>Do Consumers Really Behave “Rationally” and Maximize Utility?</i>	<i>101</i>
From Marginal Utility to the Demand Curve	103
Consumer Choice as a Trade-off: Opportunity Cost	104
Consumer’s Surplus: The Net Gain from a Purchase	105
Resolving the Diamond-Water Paradox	107
Price, Income, and Quantity Demanded	107
From Individual Demand Curves to Market Demand Curves	110
The “Law” of Demand	111
Summary	112
Key Terms	113
Questions for Review	113
Appendix: Indifference Curve Analysis	114
Geometry of Available Choices: The Budget Line	114
What the Consumer Prefers: The Indifference Curve	116
The Slopes of Indifference Curves and Budget Lines	118
The Consumer’s Choice	119
Consequences of Income Changes: Inferior Goods	121
Consequences of Price Changes: Deriving the Demand Curve	121
Summary	123
Key Terms	123
Questions for Review	124

CHAPTER 2 THE U.S. ECONOMY: MYTH AND REALITY 25**The American Economy: A Thumbnail Sketch 25****A Growing Economy . . . but with Inflation 28****The Inputs: Labor and Capital 32****The Outputs: What Does America Produce? 34***Public Opinion on Profits 35***The Central Role of Business Firms 35***Is That an American Company? 36***What's Missing from the Picture? Government 36****Conclusion: The Mixed Economy 40**

Summary 41

Key Terms 41

Questions for Review 41

Appendix: Further Perils in the Interpretation of Graphs 42

Distorting Trends by Choice of the Time Period 42

Dangers of Omitting the Origin 43

Unreliability of Steepness and Choice of Units 44

Summary 47

Questions for Review 47

CHAPTER 3 SCARCITY AND CHOICE: THE ECONOMIC PROBLEM 49**Problem: The "Indispensable Necessity" Syndrome 50****Scarcity, Choice, and Opportunity Cost 50****Scarcity and Choice for a Single Firm 52****The Principle of Increasing Costs 54****Scarcity and Choice for the Entire Society 55***A Military-Civilian Output Trade-off in Reality 55***Scarcity and Choice Elsewhere in the Economy 57****The Concept of Efficiency 59****The Three Coordination Tasks of Any Economy 60****Specialization, Division of Labor, and Exchange 60***Adam Smith (1723–1790) 61***Markets, Prices, and the Three Coordination Tasks 62****Liberal and Conservative Goals Can Both Be Served by the Market Mechanism 63**

Summary 64

Key Terms 65

Questions for Review 65

CHAPTER 4 SUPPLY AND DEMAND: AN INITIAL LOOK 67**Fighting the Invisible Hand 68***Price Controls at Valley Forge 68***Demand and the Quantity Demanded 69**