

MACROECONOMICS

PRIVATE AND PUBLIC CHOICE



Gwartney
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Sabel
Macpherson

13e

The Eight Guideposts to Economic Thinking

These eight guideposts provide the foundation for the economic way of thinking (they are discussed in Chapter 1). To do well in this course you will need to understand and be able to apply these ideas to a wide range of issues.

1. The Use of Scarce Resources Is Costly; Trade-offs Must Always Be Made.
2. Individuals Choose Purposefully — They Try to Get the Most From Their Limited Resources.
3. Incentives Matter — Choice Is Influenced in a Predictable Way by Changes in Incentives.
4. Individuals Make Decisions at the Margin.
5. Although Information Can Help Us Make Better Choices, Its Acquisition Is Costly.
6. Beware of the Secondary Effects: Economic Actions Often Generate Indirect As Well As Direct Effects.
7. The Value of a Good or Service Is Subjective.
8. The Test of a Theory Is Its Ability to Predict.

Special Topics

These Special Topics covered in the “Applying the Basics” section use the basic concepts to analyze important current-day topics.

- 1 Government Spending and Taxation
- 2 The Internet: How Is It Changing the Economy?
- 3 The Economics of Social Security
- 4 The Stock Market: Its Function, Performance, and Potential as an Investment Opportunity
- 5 The Crisis of 2008: Causes and Lessons for the Future
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- 10 School Choice: Can It Improve the Quality of Education in America?
- 11 Earnings Differences Between Men and Women
- 12 Do Labor Unions Increase the Wages of Workers?
- 13 Are We Running Out of Resources?
- 14 Difficult Environmental Cases and the Role of Government

Keys to Economic Prosperity

These keys to the economic prosperity of a nation are highlighted throughout the text.

- 1. Human Ingenuity.** Economic goods are the result of human ingenuity and action; thus, the size of the economic pie is variable, not fixed. [Economics Chapter 2; Macroeconomics Chapter 2; Microeconomics Chapter 2]
- 2. Private Ownership.** Private ownership provides people with a strong incentive to take care of things and develop resources in ways that are highly valued by others. [Economics Chapter 2; Macroeconomics Chapter 2; Microeconomics Chapter 2]
- 3. Gains from Trade.** Trade makes it possible for individuals to generate more output through specialization and division of labor, large-scale production processes, and the dissemination of improved products and production methods. [Economics Chapter 2; Macroeconomics Chapter 2; Microeconomics Chapter 2]
- 4. Invisible Hand Principle.** Market prices coordinate the actions of self-interested individuals and direct them toward activities that promote the general welfare. [Economics Chapter 3; Macroeconomics Chapter 3; Microeconomics Chapter 3]
- 5. Profits and Losses.** Profits direct producers toward activities that increase the value of resources; losses impose a penalty on those who reduce the value of resources. [Economics Chapter 3; Macroeconomics Chapter 3; Microeconomics Chapter 3]
- 6. Competition.** Competition motivates businesses to produce efficiently, cater to the views of consumers, and search for innovative improvements. [Economics Chapter 22; Microeconomics Chapter 10]
- 7. Entrepreneurship.** The entrepreneurial discovery and development of improved products and production processes is a central element of economic progress. [Economics Chapter 23; Microeconomics Chapter 11]
- 8. Productivity and Earnings.** In a market economy, productivity and earnings are closely linked. In order to earn a large income, one must provide large benefits to others. [Economics Chapter 26; Microeconomics Chapter 14]
- 9. Innovation and the Capital Market.** If the potential gains from innovative ideas and human ingenuity are going to be fully realized, it must be relatively easy for individuals to try their innovative and potentially ingenious ideas, but difficult to continue if the idea is a bad one. [Economics Chapter 27; Microeconomics Chapter 15]
- 10. Price Stability.** Maintenance of price stability is the essence of sound monetary policy; price stability provides the foundation for both economic stability and the efficient operation of markets. [Economics Chapter 15; Macroeconomics Chapter 15]
- 11. International Trade.** When people are permitted to engage freely in international trade, they are able to achieve higher income levels and living standards than would otherwise be possible. [Economics Chapter 18; Macroeconomics Chapter 18; Microeconomics Chapter 17]
- 12. Role of Government.** Governments promote economic progress when they protect individuals and their property, enforce contracts impartially, provide access to money of stable value, avoid high taxes and excessive regulation, and foster competitive markets and free international trade. [Economics Chapter 16; Macroeconomics Chapter 16]



13th edition

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Preface

This is an exciting time for the study of economics. Most of our lives have been affected by the financial crisis of 2008. Why did this crisis occur? How will it affect our economic future? Has the political response saved us from economic catastrophe, or has it made matters worse? What can we learn from previous experience with economic difficulties? These are vitally important questions that are on the minds of our students. This text addresses all of them and provides both economic analysis and empirical evidence that will enhance understanding of these critical issues.

Some argue that the Crisis of 2008 was the result of capitalist instability, greed of Wall Street bankers, and regulators who were asleep on the job. Others argue that the crisis was the result of government policies that undermined sound lending practices, manipulated interest rates, and promoted excessive debt. Who is right? Of course, the precise answer to such complex questions is debatable, but economic analysis provides considerable insight.

Throughout the life of this text, our goal has been to use the tools of economics to explain how the real world works and to do so in a clear and understandable manner. Recent economic developments have enhanced the importance of this strategy. Perhaps more than ever before, students are seeking to understand the world in which they live and the critical issues we confront. Indeed, this is a teachable moment for economics instructors. This thought was constantly on our minds, as we revised this edition and focused the core principles of economics on the central issues of our day.

Organization of the Text and Instructor Flexibility

The organization of *Economics: Private and Public Choice* is designed to provide instructors with maximum flexibility. Those using the full-length text for a two-semester course can cover either microeconomics or macroeconomics first. As in recent editions, the text is divided into core chapters and a concluding special topics section. The twenty-eight core chapters cover all of the material taught in most principles courses, and they are presented in the usual manner. Examples and data from the real world are used to reinforce the analysis. In addition, Beyond the Basics includes fourteen relatively short special topic applications on high-profile topics like Social Security, the Economics of Health Care, and the Crisis of 2008. Also included in this section are Applications that address questions such as “Is discrimination responsible for the earnings differences between men and women?” and “Are we running out of resources?.” These features are sure to grab the interest of students and are short enough for coverage during a single class period. Our own teaching experience indicates that these applications will enrich an economics course. They will also make it easier for instructors to “pick and choose” and thereby tailor the text readings to fit their own preferences and objectives.

Those teaching a microeconomics course and like to stress the importance of public choice will probably want to cover the first six chapters before beginning the core microeconomics section. Other instructors will prefer to cover only the first four chapters and then move immediately to the core microeconomics material. The book is designed for both of these options.

Those teaching macroeconomics integrating public choice will probably want to cover Chapters 5 and 6 prior to the core macroeconomics material. Others may want to move directly from Chapter 4 (or Chapter 3) to the core macro. The macroeconomics chapters have been written such that there will be no problems with either option.

The text is accompanied by a robust set of online learning tools designed to support your classroom work and an Aplia component that includes real-time, interactive tutorials,

online experiments, and automatically graded problem sets. Likewise, the book's dynamic PowerPoint presentation—considered by many to be the best in the principles market—has been further enhanced with multimedia to facilitate your teaching.

Changes in this Edition

Substantial changes in both conditions and policies have occurred in recent years. These changes are reflected fully in this edition. The core macroeconomic material has been reorganized in a manner that will make it easier to understand current issues and controversies. Economists are not of one mind with regard to fiscal policy, and a chapter has been added to provide more comprehensive treatment of this issue.

Chapter 11 presents the Keynesian view of fiscal policy and considers its historical development and evolutionary change during recent decades. Following in the Keynesian tradition, Chapter 11 highlights the importance of aggregate demand and the potential use of fiscal policy to maintain full employment equilibrium.

Chapter 12 presents alternative perspectives that highlight the importance of incentives and secondary effects. This chapter contains new sections on the impact of fiscal policy during a severe recession, fiscal stimulus and the speed of recovery, tax cuts versus spending increases, and the paradoxes of saving and spending. Taken together, these two fiscal policy chapters provide a balanced comprehensive analysis of the modern debate about the potential and limitations of fiscal policy.

Chapter 13 on Money and Banking has been updated to reflect recent changes in how the Federal Reserve controls the money supply. The impact of the Fed's power to pay interest to commercial banks on their excess and required reserves is analyzed. A new section on Recent Fed Policy, the Monetary Base, and the Money Supply has also been incorporated into the Money and Banking chapter.

Chapter 14 on Monetary Policy has been substantially revised. New sections on time lags and economic stability, measurement of shifts in monetary policy, the Taylor rule, and monetary policy and the Crisis of 2008 are now included in this chapter.

Chapter 15 on Stabilization Policy has also been substantially revised. This chapter includes a new section on what we have learned about macro policy, which highlights both points of agreement and areas of continuing debate.

The last two chapters of the core macro focus on economic growth. They highlight the importance of trade, entrepreneurship and innovation, and investment as sources of growth. Building on the work of Douglass North, Joseph Schumpeter, William Baumol, and Daron Acemoglu, these chapters focus on the institutional foundations of growth and prosperity. While one new chapter has been added, the overall length of the core macro is largely unchanged.

Three timely new features have been added to the Special Topic part of the text, while two others were omitted. The three new special topics are (1) The Crisis of 2008: Causes and Lessons for the Future, (2) Lessons From the Great Depression, and (3) Lessons From the Japanese Experience. The special topic on The Federal Budget and the National Debt was substantially revised and updated to reflect recent changes in this area. This package of applications provides instructors with powerful materials with which to address the current economic difficulties and their future implications.

Additional Text Features

Economics: Private and Public Choice retains several features that make the presentation of economics both more interesting and understandable:

- ✘ **Keys to Economic Prosperity.** Students often fail to appreciate the organizational and institutional factors that are the foundation for economic progress. In order to help remedy this situation, we have incorporated a “Keys to Economic Prosperity”

feature that highlights the importance of factors like gains from trade, secure property rights, competition, and free trade as sources of economic prosperity. In all, twelve key factors that underlie modern economic prosperity are highlighted at appropriate places throughout the text and are also listed on the inside of the front cover.

- ✗ **Economics at the Movies.** Both the macro and micro edition again contain box features throughout the text called “Economics at the Movies.” The boxes describe various scenes from popular movies that reflect economic concepts. A number of instructors, including the authors, now use clips from popular movies to stimulate student interest and drive home the importance of these concepts. The instructor’s manual provides more ideas about how this can be done effectively.
- ✗ **Applications in Economics.** “Applications in Economics” boxes apply economic theory to real-world issues and controversies. These features illustrate the importance and power of the principles covered in the text.
- ✗ **Measures of Economic Activity.** The “Measures of Economic Activity” boxes explain how important economic indicators such as the unemployment rate and the index of leading indicators are assembled and what they mean.
- ✗ **Outstanding Economists.** Boxes throughout the text highlight the lives of major economists and focus on how their work has contributed to the development of economics.
- ✗ **Myths of Economics.** These boxed articles dispel commonly held fallacies of economic reasoning. Because Students they are tomorrow’s leaders, we believe that they should be aware of common economic misperceptions that tend to hamper a nation’s economic progress.
- ✗ **Chapter Focus Questions and Closing Key Point Summaries.** Each chapter begins with four or five questions that summarize the focus of the chapter. At the end of each chapter, the Key Points section provides the student with a concise statement of the material covered in the chapter (the chapter learning objectives). These two features help students better integrate the material into the broader economic picture.
- ✗ **Critical Analysis Questions.** Each chapter concludes with a set of discussion questions and problems designed to test the student’s ability to analyze economic issues and to apply economic theory to real-world events. Appendix B at the end of the text contains suggested answers for approximately half of these questions.

Supplementary Materials

For the Student

Coursebooks The Coursebooks for this edition were prepared by our coauthor Russell Sobel and are now available not in two but three versions, covering all three courses: economics, microeconomics, and macroeconomics. The Coursebooks are more than study guides. Each includes numerous multiple-choice, true/false, and discussion questions to help students self-test their knowledge of each chapter. Answers and short explanations for most questions are provided in the back of the Coursebooks. Each chapter also contains problem and project exercises designed to improve the student’s knowledge of the mechanics. Like the textbook, the Coursebooks are designed to help students develop the economic way of thinking.

Support Web Site (<http://www.cengage.com/economics/gwartney>) Valuable resources can be found on the text’s online support site. Students will find interactive flash cards, online practice quizzes, and more.

The Eight Guideposts to Economic Thinking

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For the Instructor

We are sure that many of the features incorporated in this textbook will help you become a better teacher and make your classes more interesting to students. Personally, we have incorporated the Keys to Economic Prosperity series, movie clips, ABC Video clips, clips by John Stossel, homework assignments, and online quiz questions into our own classes with great success. The full set of supplements that accompany the book includes the following:

Aplia Aplia (www.aplia.com) has joined forces with South-Western, the leading publisher for principles of economics and finance, to create the Aplia Integrated Textbook Solution. More students are currently using an Aplia product for principles of economics than those who are using all other Web-based learning programs combined. Because the homework in Aplia is automatically graded, you can assign homework more frequently to ensure your students are putting forth full effort and getting the most out of your class.

ABC News Videos This supplement consists of high-interest clips from current news events as well as historic raw footage going back forty years. Perfect for discussion starters or to enrich your lectures and spark interest in the material in the text, these brief videos provide students with a new lens through which to view the past and present, one that will greatly enhance their knowledge and understanding of significant events and open up new dimensions in learning. Clips are drawn from such programs as *World News Tonight*, *Good Morning America*, *This Week*, *PrimeTime Live*, *20/20*, and *Nightline*, as well as numerous ABC News specials and material from the Associated Press Television News and British Movietone News collections. Your South-Western Publishing representative will be happy to provide a complete listing of the videos and policies addressed.

Stossel in the Classroom Videos Most instructors are looking for ways to get their students engaged and excited while developing their critical thinking skills. Thousands of teachers across the country have experienced the benefits of using John Stossel's engaging videos from ABC 20/20. A team of instructors, including authors of this text, worked with ABC and Stossel to put together thirty-one short video clips designed especially for use in college-level economics. The DVDs also contain an *Instructor's Manual* with discussion questions, testing material, related activities, and other ideas about how to use the clips most effectively. <http://stosselintheclassroom.org/>

Tomlinson Learning Path Videos The Tomlinson videos are an online multimedia video lecture series that provide students with instructional assistance 24/7. Students can watch these segments over and over as they prepare for class, review topics, and study for exams. Lecture notes and quizzes for each segment are also available. Professors may require students to view the videos before class to leave the class time free for activities or further explanation. www.cengage.com/economics/tomlinson

JoinIn Turning Point® CD JoinIn is a response system that allows you to transform your classroom and assess your students' progress with instant in-class quizzes and polls. Our exclusive agreement to offer TurningPoint® software lets you pose book-specific questions and display students' answers seamlessly within the Microsoft PowerPoint slides of your own lecture, in conjunction with the "clicker" hardware of your choice. Enhance how your students interact with you, your lecture, and each other. For college and university adopters only. Contact your local South-Western representative to learn more.

Contemporary Issues in Economics We are proud to introduce Cengage's collection, *Contemporary Issues in Economics* as a resource for in-depth coverage of key economic topics. This collection includes readings on major issues pertaining to education, health care, Social Security, unemployment, inflation, and international trade. Our collection

examines issues that interest students, while building on core economic principles. By delving deeply into timely interesting issues, students begin to see fundamental economic concepts as important in understanding issues that affect them personally as well as in understanding today's headlines. To view the readings and obtain more information about how to enhance your course with this material, visit www.textchoice.com/econ_issues.

WebTutor™ Toolbox for WebCT, Blackboard, and eCollege WebTutor will allow you to jumpstart your course whether you want to simply Web-enable your class or put an entire course online. Using a WebTutor cartridge, it's easy to add, edit, reorganize, or delete content customized for *Economics: Private and Public Choice*. The content includes quizzing, flash cards, and more. To find out more about WebTutor, contact your local South-Western representative. (Other platform choices are available upon request.)

Test Banks The Test Banks for the thirteenth edition were prepared by the author team with the assistance of Joe Calhoun and David Gwartney. The authors have worked hard to update and improve the Test Banks for this edition. The two Test Banks contain approximately 7,000 questions—multiple-choice and short answer. Within each chapter, the questions correspond to the major subheadings of the text. The first ten questions of each chapter are suitable for use as a comprehensive quiz covering the material of the chapter. The multiple-choice questions from the Coursebook and Online practice quizzes are also included in special sections of the Test Bank. Instructors who would like to motivate their students to study the Coursebook and Online practice quizzes can easily use these questions and incorporate them into their quizzes and exams.

Computerized Test Banks (ExamView®) The computerized Test Banks for this edition have been enhanced significantly. ExamView contains all of the questions in the printed Test Bank so that you create and customize tests in minutes. You can easily edit and import your own questions and graphics and edit and maneuver existing questions. You can also use ExamView to test and grade online.

PowerPoint We believe that our PowerPoint presentation, prepared by Joe Connors, is the best you will find in the principles market. The presentation includes chapter-by-chapter lecture notes with fully animated, hyperlinked slides of the textbook's exhibits. Its dynamic graphs and accompanying captions make it easy for instructors to present (and students to follow) sequential changes. The graphs are also used to highlight various relationships among economic variables. In order to facilitate classroom discussion and interaction, questions are strategically interspersed throughout the chapters to help students develop the economic way of thinking. Instructions explaining how professors can easily add, delete, and modify slides in order to customize the presentation to their liking are included. If instructors want to make the PowerPoint presentation available to students, they can place it on their Web site (or the site for their course).

Instructor's Manual and Instructor's Resource CD The *Instructor's Manual* was prepared by our coauthor David Macpherson. It contains special sections for Advanced Placement instructors prepared by James Chasey and Francis McMann, two of the nation's leading A/P instructors. Information on how to use and modify the PowerPoint material is found at the beginning of the *Instructor's Manual*. Also included at the front of the manual is information about Examview, the computerized testing software that accompanies the book. The manual is divided by chapters, and each chapter is divided into three parts. The first part consists of a detailed chapter outline in lecture-note form. It is designed to help instructors organize their notes to match the thirteenth edition of the book. Instructors can easily prepare detailed, personalized notes by revising the computerized version of the lecture notes on the *Instructor's Resource CD*. The second part of each chapter contains teaching tips, sources of supplementary materials, and other helpful information. Part 3 of each chapter consists of in-class economic games and experiments. Contributed in part by

Professor Charles Stull of Kalamazoo College, the games are highly popular with many instructors. We hope you will try them.

The *Instructor's Resource CD* contains the key supplements designed to aid instructors, including the content from the *Instructor's Manual*, Test Banks, and PowerPoint lecture and exhibit slides for overhead use.

Support Web Site for Instructors (www.cengage.com/economics/gwartney) This password-protected Web site includes some of the same essential resources that can be found on the *Instructor's Resource CD*, including instructor's manuals and test banks in Microsoft Word, and the PowerPoint lecture and exhibit slides. To access the site to download these supplements, register online at <http://www.cengage.com/economics/gwartney>.



A Note to Instructors

As we try 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 us in care of Cengage South-Western, 5191 Natorp Blvd., Mason, OH 45040. Such letters are invaluable, and we are glad to receive both praise and suggestions for improvement. Many such suggestions have found their way into this new book.

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A Note to Students

This textbook contains several features we think will help you “maximize” (a good economic term) the returns of your study efforts. Here are some of the things that will help you and a few tips for making the most of them:

- ✘ Each chapter begins with a series of focus questions that communicate the central issues of the chapter. Before you read the chapter, briefly think about the focus questions, why they are important, and how they relate to the material in prior chapters.
- ✘ The textbook is organized in the form of an outline. The headings within the text (in blue) are the major points of the outline. Minor headings are subpoints under the major headings. In addition, important subpoints within sections are often set off and numbered. Bold italicized type is used to highlight material that is particularly important. Sometimes “Thumbnail Sketches” are included to recap material and help the reader keep the important points mentally organized. Careful use of the headings, highlighted material, and the Thumbnail Sketches will help you master the material.
- ✘ A “Key Points” summary appears at the end of each chapter. Use the summary as a checklist to determine whether you understand the major points of the chapter.
- ✘ A review of the exhibits and illustrative pictures will also provide you with a summary of the key points of each chapter. The accompanying captions briefly describe the economic phenomena illustrated by the exhibits.
- ✘ The key terms introduced in each chapter are defined in the margins. As you study the chapter, go over the marginal definition of each key term as it is introduced. Later, you may also find it useful to review the marginal definitions. If you have forgotten the meaning of a term introduced earlier, consult the glossary at the end of the book.
- ✘ The boxed features go into more depth on various topics without disrupting the flow of the text. In general, the topics of the boxed features have been chosen because they are a good application of the theory described in the book or because students tend to be interested in them. The boxed features will supplement the text and enhance your understanding of important economic concepts.
- ✘ The critical analysis questions at the end of each chapter are intended to test your understanding of the economic way of thinking. Answering these questions and solving these problems will greatly enhance your knowledge of the material. Answers to approximately half of these questions are provided in Appendix B.

If you need more practice, be sure to obtain a Coursebook and solve the questions and problems for each chapter. The Coursebook also contains the answers to the multiple-choice questions and a brief explanation of why an answer is correct (and other choices incorrect). In most cases, if you master the concepts of the test items in the Coursebook, you will do well on the quizzes and examinations of your instructor. For extra help, in addition to the Coursebook, visit the book’s student support Web site <http://www.cengage.com/economics/gwarty> for online quizzes and other tutorials.

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We would also like to express our appreciation to Chuck Skipton of the University of Tampa and Joe Connors of Florida State University for their contribution to what we believe is the very best set of PowerPoint slides accompanying an introductory economics text. We also appreciate the contributions of Joseph Calhoun, Lynn MacDonald, Dirk Mateer, and David Gwartney to the Test Bank, online quizzes, and other supplementary materials. James Chasey and Francis McMann provided valuable suggestions and handled the parts of the *Instructor's Manual* designed for those teaching the Advance Placement macroeconomics and microeconomics courses. Robert Lawson of Auburn University assisted us with the preparation of several exhibits. The text still bears an imprint of the contributions of Woody Studenmund of Occidental College and Gary Galles of Pepperdine University, who assisted us in numerous ways with past editions.

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Brief Contents

Part 1: The Economic Way of Thinking	1	
Chapter 1	The Economic Approach	2
Chapter 2	Some Tools of the Economist	27
Part 2: Markets and Government	51	
Chapter 3	Supply, Demand, and the Market Process	52
Chapter 4	Supply and Demand: Applications and Extensions	80
Chapter 5	Difficult Cases for the Market, and the Role of Government	105
Chapter 6	The Economics of Collective Decision Making	122
Part 3: Core Macroeconomics	145	
Chapter 7	Taking the Nation's Economic Pulse	146
Chapter 8	Economic Fluctuations, Unemployment, and Inflation	169
Chapter 9	An Introduction to Basic Macroeconomic Markets	189
Chapter 10	Dynamic Change, Economic Fluctuations, and the AD–AS Model	215
Chapter 11	Fiscal Policy: The Keynesian View and Historical Perspective	235
Chapter 12	Fiscal Policy: Incentives, and Secondary Effects	255
Chapter 13	Money and the Banking System	275
Chapter 14	Modern Macroeconomics and Monetary Policy	301
Chapter 15	Stabilization Policy, Output, and Employment	323
Chapter 16	Creating an Environment for Growth and Prosperity	341
Chapter 17	Institutions, Policies, and Cross-Country Differences in Income and Growth	359
Part 4: International Economics	385	
Chapter 18	Gaining from International Trade	386
Chapter 19	International Finance and the Foreign Exchange Market	409
Part 5: Applying the Basics: Special Topics in Economics	443	
<i>Special Topic 1:</i>	Government Spending and Taxation	444
<i>Special Topic 2:</i>	The Internet: How Is It Changing the Economy?	447
<i>Special Topic 3:</i>	The Economics of Social Security	455
<i>Special Topic 4:</i>	The Stock Market: Its Function, Performance, and Potential as an Investment Opportunity	466
<i>Special Topic 5:</i>	The Crisis of 2008: Causes and Lessons for the Future	477
<i>Special Topic 6:</i>	Lessons from the Great Depression	491
<i>Special Topic 7:</i>	Lessons from the Japanese Experience	505
<i>Special Topic 8:</i>	The Federal Budget and the National Debt	517
Appendix A	General Business and Economics Indicators for the United States	529
Appendix B	Answers to Selected Critical Analysis Questions	537
Glossary		561
Index		573

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