

# Study Guide for The Economy Today

**Fourth Edition** 

# Bradley R. Schiller

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# To the Instructor

This Study Guide is an important part of the complete and fully integrated textbook package called The Economy Today. Students who use this Study Guide on a continuous basis should be able to remember what they have read in their textbook and heard in your lecture. It should enable them to apply to examinations the principles they learn and, more important, should help them recognize the same principles at work in their daily experiences. Each section of each chapter has a particular objective, which is described in the following paragraphs.

The Quick Review and Learning Objectives sections provide brief summaries of the basic contents of the corresponding text chapters and outline the important areas of the Study Guide. Each learning objective is keyed to specific pages in the text and to specific questions and problems that follow. Look at page 2 for examples.

Economic terminology is often an obstacle to new students in economics. Thus the Key-Term Review and Crossword Puzzle sections of the Study Guide provide practice in the use of terminology. Both sections help the students to link economic terms to the appropriate economic concepts. The Study Guide reinforces the terminology by repetition. However, we have taken pains not to make the repetition burdensome. The crossword puzzles we have introduced in some of the chapters, for example, help to make the repetition fun.

The *True or False* and *Multiple Choice* sections help the student advance from memorizing terminology to applying economic principles in a familiar problem-solving setting. This will help greatly in their preparation for exams.

The *Problems and Applications* sections let the students discover economic principles for themselves. Students not only learn the techniques that economists use, but they also discover the basis for the economic principles they have learned.

The section called *Common Errors* was introduced in the first edition of this book in 1980, and at that time it was unique to this *Study Guide*. Since then a number of competing books have begun including similar sections, a strong indicator of its usefulness to students and its popularity with instructors. It is our feeling that, semester after semester, students have difficulty with the same concepts and make the same mistakes; hence, the name *Common Error*. We've tried to draw attention to some of these problem areas and provide explanations using the appropriate economic principles. You may wish to add to those we have provided.

Another unique feature of this *Study Guide* is what we call the "media exercise." The media exercises are contained in the *Problems and Applications* section of each chapter. Each one directs the students to reread a certain newspaper, magazine, or other media article from among those interspersed throughout the text. The students then answer a series of questions based on the article, using the economic principles they have learned in the chapter. The media exercises should help the students see economic principles at work in the world around them, and make them aware of how to get the "economics" out of a critical reading of the "news" long after they leave the economics classroom.

The Study Guide provides an alternative to the memorization: it directs the student in applying economic principles. The exercises and crossword puzzles should actually stimulate interest in economics. We have found that our students showed great satisfaction from the discovery of the ideas embedded in the exercises as well as the neatness of completed problems and mathematical calculations. The exercises focusing on current or historic events also generated interest among the students. We also found that our students enjoyed making up their own crossword puzzles.

# To the Student

This Study Guide is designed to be used with The Economy Today, Fourth Edition, by Bradley R. Schiller. Working through the Study Guide should reinforce what you have learned in the textbook and help you to recognize economic principles in your daily experiences.

Note the following points in the various sections of each of the chapters:

- The Quick Review provides a brief summary of the concepts in the corresponding text chapter. If you are
  not comfortable with the terminology and concepts in this review, you should reread the appropriate sections
  of the text chapter.
- The Learning Objectives focus on the basic information in each text chapter and provide outlines for material to be covered in the Study Guide. The learning objectives are keyed to questions and problems that follow and to pages in the text. If you have difficulty with a particular idea, you can quickly find the text material and review it.
- The Key-Term Review and Crossword Puzzles give you practice in the use of terminology in the specific chapters. As a learning aid, you are encouraged to write out the definitions of the key economic terms.
- The *True or False* and *Multiple Choice* questions test your understanding of the basic economic principles discussed in the text chapter.
- The *Problems and Applications* section contains one or more real-world problems, which allow you to work out in a practical way the economic principles that you have been studying.
- Nearly all chapters contain a "media exercise" that refers you to specific newspaper, magazine, or other
  articles reprinted in the text. These exercises will assist you in developing your critical thinking skills.
- The Common Errors section identifies some of the errors that students often make and explains the correct principles. This is a very effective way to help you discover and correct your mistakes.
- Answers to all problems, exercises, and questions are provided at the end of each chapter of the Study Guide, so you can quickly check your answers and go back and review where necessary.

# **Acknowledgments**

This Study Guide is now in its fourth edition, and we have many people to thank for their contributions. Our greatest thanks must go to our students, upon whom the exercises in the first edition of the Study Guide were tested. Their patience, creativity, and astuteness provided a much better Study Guide, one from which other students will benefit. Contributors of the crossword puzzles include Sidi Habi, Patricia Eason, Margaret Gatchell, Louise Oller, and Robin Burdette. Richard Bayer originated two excellent exercises in the macroeconomics section. All these contributions have been retained in this edition.

The teachers enrolled in the 1982 University of Texas at Arlington Summer Institute in Economics worked through the first fifteen chapters of an early draft of the second edition manuscript. The participants are too numerous to cite individually, but their thoroughness is certainly appreciated. Any errors that remain are, of course, our responsibility. Bryce Jones, Sheldon Stahl, and Gerald Miller, all of Rockhurst College, provided comments and support that helped make the project possible.

We happily acknowledge the help and support of the Random House staff. We know of no other publisher that has made a greater commitment to a book of this type. Special thanks on this edition are extended to June Smith, Bonnie Binkert, and Catherine Woods. We appreciate their gracious attitude, calm demeanor, and competence displayed throughout the entire process. Project editor Barbara Gerr was delightful to work with, and copy editor Elaine Romano was outstanding as well.

We remember with special fondness the late Mary Griffin, who was the project editor for the first edition. The success of the *Study Guide* is due to her role as a relentless taskmaster who set high standards for two rookie authors. The typists for each of the four editions—Nancy Bloodgood Sproba, Mildred Simms, Cyndy Carver, and Eileen Garland—were superb. Finally we continue to value the friendship of Paul Shensa, who got us started with Random House over ten years ago.

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# **Contents**

To the Instru		iii	
To the Student			
Acknowledge	ments	vii	
SECTION I	BASICS	1	
1.	An Overview	1	
2.	Supply and Demand	13	
3.	The Public Sector	33	
4.	National-Income Accounting	46	
SECTION II	MACROECONOMICS	5 <i>7</i>	
PART A	MAJOR PROBLEMS	57	
5.	The Business Cycle	57	
6.	Unemployment	69	
7.	Inflation	80	
PART B	POLICY OPTIONS: THE KEYNESIAN APPROACH	92	
8.	Aggregate Spending	92	
9.	Potential Instability	113	
10.	Fiscal Policy	126	
PART C	POLICY OPTIONS: MONETARY APPROACHES	142	
11.	Money and Banks	142	
12.	The Federal Reserve System	154	
13.	Monetary Policy	169	
PART D	POLICY OPTIONS: THE SUPPLY-SIDE APPROACH	184	
14.	Supply-Side Policies	184	
PART E	CURRENT POLICIES	202	
15.	Theory and Reality	202	
16.	The National Debt	202	
1 <i>7</i> .	Global Views	230	
18.	Long-Term Growth: Sources and Limits	248	
SECTION III	MICROECONOMICS	261	
	PRODUCT MARKETS: BASIC THEORY	261	
19.	The Demand for Goods	261	
20.	The Costs of Production	280	
21.	Profits and the Supply Decision	300	

22.	Competitive Markets	319
23.	Monopoly	337
24.	Imperfect Competition	355
25.	Market Power in the U.S. Economy	370
PART B	PRODUCT MARKETS: ISSUES	381
26.	The Deregulation of Business	381
27.	The Farm Problem	391
28.	Pollution	401
29.	Productivity of the Firm	413
PART C	FACTOR MARKETS: BASIC THEORY	424
30.	The Supply of Labor	424
31.	The Demand for Labor	438
32.	Power in Labor Markets	453
33.	Rent, Interest, and Profit	468
PART D	FACTOR MARKETS: ISSUES	483
34.	Taxes: Equity vs. Efficiency	483
35.	Work vs. Welfare	495
	INTERNATIONAL ECONOMICS AND COMPARATIVE SYSTEMS	503
36.	International Trade	503
37.	International Finance	515
38.	International Development	529
39.	Socialist Planning	538

### **SECTION I** BASICS

# Chapter 1 An Overview

#### **Quick Review**

The output of the U.S. economy is well over \$4 trillion per year. This is simply the economist's way of summarizing the total volume of goods and services produced in the economy by market participants like you and me. In other words, "The economy is us."

Although our annual production of goods and services is impressive, our resources are not sufficient to satisfy all of our wants. Society's wants are infinite and insatiable while our available resources are relatively fixed. As a result, we (like all societies) are forced to choose which goods and services will be produced and which will not. Economists illustrate these choices by drawing a production-possibilities curve. This curve shows the combinations of goods and services a society could produce if it were operating efficiently and all of its resources were fully employed. The production-possibilities curve appears bowed out from the origin because of the law of increasing opportunity costs.

Every society has to decide what goods and services it wants to produce. In the United States our choices are determined by the market mechanism. Through the market mechanism the production and consumption decisions of individuals directly affect the allocation of resources. These individual decisions are supplemented with generous doses of public-sector activity. When the market mechanism leaves some of our needs unmet—our desire for clean air and water, for example—the public sector must do the job. Market systems do not automatically generate pollution-control mechanisms. Such market imperfections must be overcome by government activity. In some economies the market mechanism is not allowed to work efficiently. Planned economies, like that of the Soviet Union, are good examples of this.

In studying the economy, it is useful to break economics into two categories: microeconomics and macroeconomics. Microeconomics focuses on a specific individual, firm, industry, or government agency; macroeconomics focuses on the entire economy.

## **Learning Objectives**

the f	After reading Chapter 1 and doing following exercises, you should:	True or false	Multiple choice	Problems and applications	Common errors	Pages in the text
1.	Know what the science of economics is concerned with.	10	1–3,5		2,3	19–23
2.	Know the factors of production.	2	9		1	
3.	Understand opportunity costs and how to represent them.	1,3,12	6–8	2,3		6–8
4.	Be able to draw and interpret a production-possibilities curve.	4,16	12,13	1,3		8–10
5.	Be able to explain the law of increasing opportunity costs.	11	14	2,3		11–13
6.	Know how to represent growth and technological change in terms of shifts of the production-possibilities curve.	13,14	9,10	1		14–15
7.	Be able to describe different mechanisms for allocating resources.	6,8	4			16–19
8.	Know how the market mechanism allocates resources.	9				16–18
9.	Know several different types of market imperfections.	5,7	11			17–18
10.	Be able to differentiate between micro- economics and macroeconomics.	15,17	15,16			19–20

## **Key-Term Review**

Review the following terms; if you are not sure of the meaning of any term, write out the definition and check it against the Glossary in the text.

ceteris paribus	macroeconomics
economic growth	market mechanism
economics	microeconomics
externalities	mixed economy
factors of production	opportunity cost
law of increasing opportunity costs	production possibilities

Fill in the blank following each of the statements below with the appropriate term from the list above.

1.	A Latin phrase meaning "all other things being equal" is	1.	
2.	The branch of economics that focuses on the activities of individual decision-making units is	2.	
3.	When economists say that to have more schools we must give up houses, they are illustrating the principle of	3.	

	4		When market prices signal what goods and services should be produced, the allocation of resources is being accomplished by the	4.	
	5	•	Those things that are transformed into final goods and services desired by society are	5.	
	6	•	The branch of economics that focuses on the behavior of the entire economy is	6.	
	7	•	A curve showing the various combinations of goods and services that a society can produce with its scarce resources is a curve.	7.	
	8		The production-possibilities curve is bowed out because of the	8.	
	9		When the activity of a producer or consumer imposes costs or benefits on someone else, these costs or benefits are called	9.	
t.	10		The science that studies how societies allocate scarce resources is	10.	
٠	11		Much of the resource allocation in the United States is done through the public sector, indicating that we have a	11.	
	12		Where there is an increase in real output there is	12.	
Tr	ue	OI	False: Circle your choice.		
T	F	1.	Students do not pay tuition in elementary school, so i	n this	case education is a free good.
T	F	2.	Goods are scarce because society's desire for them exceeds society's ability to produce them.		
T	F		. If a commodity has a market price that is greater than zero, it must be scarce.		
T	F	4.	<ol> <li>A production-possibilities curve can only be drawn if a scarce resource prevents production of as much as we want of a commodity.</li> </ol>		
T	F	5.	The market-directed or price-directed economy is capaties without intervention by government.	able o	f solving the problems created by externali-
T	F	6.	The U.S. economy is referred to as a mixed economy be public sector (government).	ecaus	e some of our resources are allocated by the
T	F	7.	When a factory pollutes the air we breathe, this situat	ion is	known in economics as an externality.
T	F	8.	In the U.S. market system, the signals for deciding h		

T Economic Advisers.

9. The distribution of income largely determines the kinds of goods and services the economy will produce. T

T F 10. The task of economic theory is to explain and predict the economic behavior of market participants.

T F 11. One reason that the production-possibilities curve is bowed out is that the efficiency with which resources are used in production varies.

T F 12. If the economy is fully and efficiently employing its resources, then the only way to acquire more of one good is to accept less of something else.

T F 13. Technological advance shifts the production-possibilities curve inward.

T Т Т T

Т

T

- T F 14. When the economy experiences declining productivity, then the production-possibility curve is likely to be shifting inward.
- T F 15. Microeconomics focuses on the economy as a whole.
- T F 16. The slope of the production-possibilities curve is related to the idea of opportunity cost.
- T F 17. Economic growth is a major economic goal in macroeconomics.

## Multiple Choice: Select the correct answer.

 1.	Which of the following best describes the subject matter covered by principles of economics?  (a) How the stock market works.  (b) How to go into business for yourself.  (c) How the economy allocates its scarce resources.  (d) Why the U.S. economy outperforms the Soviet economy.
 2.	<ul> <li>Which of the following best describes the term "resource allocation"?</li> <li>(a) How one spends one's income.</li> <li>(b) How one decides which bank to patronize.</li> <li>(c) How one decides which stocks and bonds to buy.</li> <li>(d) Which goods and services society will produce with the land, labor, and capital available.</li> </ul>
 3.	<ul> <li>In economics, what does scarcity mean?</li> <li>(a) That when there is a shortage of a particular good, the price will rise.</li> <li>(b) That very few buggy whips are being manufactured nowadays.</li> <li>(c) That society's desires exceed the want-satisfying capability of the resources available to satisfy those desires.</li> <li>(d) None of the above.</li> </ul>
 4.	Which of the following best describes the way resources are allocated in the U.S. economy?  (a) By tradition.  (b) By command.  (c) By markets.  (d) By government.
 5.	Which of the following are considered scarce in the U.S. economy?  (a) Hamburgers.  (b) Automobiles.  (c) Petroleum products.  (d) All of the above.
 6.	I plan on going to a \$5 movie this evening instead of studying for an exam. The total opportunity cost of the movie:  (a) Depends on how I score on the exam.  (b) Is \$5.  (c) Is what I could have purchased with the \$5 plus the study time I forgo.  (d) Is the forgone studying I could have done in the same time.
 7.	<ul> <li>The opportunity cost of installing a traffic light at a dangerous intersection is:</li> <li>(a) Negative, since it will reduce accidents.</li> <li>(b) The cost of the stoplight plus the cost savings from a reduction in the number of accidents.</li> <li>(c) The time lost by drivers who approach the intersection when the light is red.</li> <li>(d) The best possible alternative bundle of other goods or services that must be forgone in order to build and install the traffic light.</li> </ul>

8.	(a) "The economy is us."  (b) The fee for a visit to the doctor's office has increased.  (c) Parking meters have been installed.  (d) The idea of opportunity cost.
9.	<ul> <li>Which of the following events would cause the production-possibilities curve to shift inward?</li> <li>(a) The labor supply grows.</li> <li>(b) New factories are built.</li> <li>(c) A technological breakthrough occurs.</li> <li>(d) None of the above.</li> </ul>
10.	<ul> <li>Which of the following events would cause the production-possibilities curve to shift outward?</li> <li>(a) The economy grows.</li> <li>(b) A new, strong plastic is developed for use in building houses.</li> <li>(c) More women enter the labor force.</li> <li>(d) All of the above would cause such a shift.</li> </ul>
11.	The market mechanism in the United States generates a distribution of income that is viewed as:  (a) Equal, since everyone gets the same income.  (b) Equitable, since public policy does not tamper with it.  (c) Both equal and equitable, since they mean the same thing.  (d) Inequitable, apparently, since we change it through the activities of the public sector.
12.	The slope of the production-possibilities curve provides information about:  (a) The growth of the economy.  (b) Technological change in the economy.  (c) Opportunity costs in the economy.  (d) All of the above.
13.	The bowed-out shape of the production-possibilities curve indicates:  (a) Increasing opportunity costs.  (b) Externalities.  (c) Market imperfections.  (d) A mixed economy.
14.	The law of increasing opportunity costs explains:  (a) How everything becomes more expensive as the economy grows.  (b) The shape of the production-possibilities curve.  (c) Inflation.  (d) All of the above.
15,	Which of the following are major economic goals?  (a) Full employment.  (b) Price stability.  (c) An equitable distribution of income.  (d) All of the above.
16.	Macroeconomics focuses on the performance of:  (a) Individual consumers.  (b) Firms.  (c) Government agencies.  (d) None of the above

### **Problems and Applications**

#### Exercise 1

This exercise is similar to the problem at the end of Chapter 1 in the text. It provides practice in drawing and interpreting a production-possibilities curve and demonstrating shifts of such a curve.

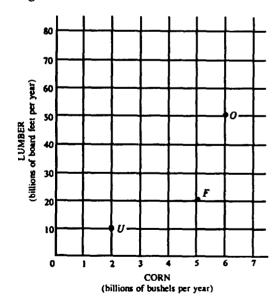
A production-possibilities schedule showing the production alternatives between corn and lumber is presented in Table 1.1. Graph combination A in Figure 1.1 and label it. Do the same for combination B. In going from combination A to combination B, the economy has sacrificed \_\_\_\_\_\_\_ billion board feet of lumber production per year and has transferred the land resources to production of \_\_\_\_\_\_ billion bushels of corn per year. The opportunity cost of corn in terms of lumber is \_\_\_\_\_\_ board feet per bushel.

Table 1.1

Quantity of corn (billions of bushels per year)	Quantity of lumber (billions of board feet per year)
0	50
1	48
2	44
3	38
4	30
5	20
6	0
	(billions of bushels per year)  0 1 2 3 4 5

2. You have determined the opportunity cost of corn when the economy is initially producing no corn (combination A). Using the information in Table 1.1, graph the rest of the production-possibility combinations in Figure 1.1 and label each of the points with the appropriate letter.

Figure 1.1



3. When Table 1.2 is completed, it should show the opportunity cost of corn at each possible combination of lumber and corn production in the economy. Opposite "1st billion bushels" insert the number of board feet per year of lumber that is sacrificed when the economy shifts from combination A to combination B. Complete the table for each of the remaining combinations.

Table 1.2

Corn production (billions of bushels per year)	Opportunity cost of corn in terms of lumber (billions of board feet per year)
1st billion bushels	
2nd billion bushels	
3rd billion bushels	
4th billion bushels	
5th billion bushels	
6th billion bushels	

- 4. From Table 1.2 it is apparent that as more corn is produced (as the economy moves from combination A toward combination G), the opportunity cost of corn \_\_\_\_\_\_ (falls, rises, remains the same), which illustrates the law of \_\_\_\_\_.
- 5. Suppose that lumber companies begin to clear-cut forest areas instead of cutting them selectively. Clear-cutting improves the economy's ability to produce lumber but not corn. Table 1.3 describes such a situation. Using the information in Table 1.3, sketch the new production-possibilities curve in Figure 1.1 as you did the initial production-possibilities curve based on Table 1.2. In the adoption of which combination does the use of clear-cutting fail to change the amount of corn and lumber?

Table 1.3

Combination	Corn (billions of bushels per year)	Lumber (billions of board feet per year)
A'	0	75
B'	1	72
C′	2	66
D'	3	57
E'	4	45
F'	5	30
G'	6	0

6.	The production-possibilities curve after the introduction of clear-cutting is
	(outside, inside, the same as) the earlier curve. As a result of clear-cutting, the opportunity cost of
	corn has (increased, decreased).

7.	Stuc	ly Figure 1.1 and decide which of the combinations shown (U, F, O) demonstrates each of the
	follo	owing. (Hint: Check the answers at the end of the chapter to make sure you have diagrammed
	the p	production-possibility curve in Figure 1.1 correctly.)
	(a)	Society is producing at its maximum potential. Combination
	(b)	Society may have some unemployed or underemployed resources. Combination
	(c)	Society cannot produce this combination. Combination
		Society might be able to produce this combination if technology improved but cannot produce it with current technology. Combination
	(e)	If society produces this combination, some of society's wants will go unsatisfied unnecessarily. Combination

#### Exercise 2

The following exercise shows how to recognize and infer the concept of production possibilities from statements of public officials.

In a speech before the American Society of Newspaper Editors on April 16, 1953, President Eisenhower stated:

Every gun that is made, every warship launched, every rocket fired signifies, in the final sense, a theft from those who hunger and are not fed, those who are cold and are not clothed. This world in arms is not spending money alone. It is spending the sweat of its laborers, the genius of its scientists, the hopes of its children. . . . This is not a way of life at all in any true sense. Under the cloud of threatening war, it is humanity hanging from a cross of iron.

Answer the following questions on the basis of the preceding quotation:

- 1. What factors of production did Eisenhower point to as the resources that limit our production possibilities?
  - (a) Guns, warships, rockets.
  - (b) Food, clothes.
  - (c) Money.
  - (d) Laborers, scientists, and the hopes of our children.
- 2. What are the final goods and services that society desires?
  - (a) Guns.
  - (b) Warships.
  - (c) Clothes.
  - (d) All of the above.
- 3. What would be placed on one of the axes of the production-possibilities curve that Eisenhower has implicitly described?
  - (a) Guns, warships, rockets, and other armaments.
  - (b) Laborers, scientists, and other labor.
  - (c) Money.
  - (d) None of the above.
- 4. Which of the following is the opportunity cost of armaments (guns, warships, and rockets)?
  - (a) The amount of clothing or food given up to produce a given quantity of armaments.
  - (b) The dollar value of armaments to the national defense.
  - (c) The amount of money that Congress appropriates for purchasing armaments.
  - (d) None of the above.
- 5. Implicitly, President Eisenhower recommended that there be greater:
  - (a) Expenditure on armaments relative to clothing.
  - (b) Expenditure on clothing and on food relative to armaments.
  - (c) Development of labor, genius, and hopes to make more armaments, food, and clothing possible.
  - (d) Expenditure of money for all of society's needs.

- 6. If Eisenhower's speech achieved a cutback in production of armaments and greater production of food and clothing, then, assuming the law of increasing opportunity costs applies, the opportunity cost of:
  - (a) Both armaments and clothing-food should rise.
  - (b) Both armaments and clothing-food should fall.
  - (c) Armaments should fall while the opportunity cost of food-clothing should rise.
  - (d) Armaments should rise while the opportunity cost of food-clothing should fall.

#### Exercise 3

Newspaper articles contain a great deal of information about the trade-offs necessary in producing different goods and services. To describe the trade-off, the articles should provide certain information. By using one of the articles in the text, this exercise will show the kind of information to look for. If your professor makes a newspaper assignment for this chapter, this exercise will provide an example of how to do it.

Reread the article in Chapter 1 entitled "Looting the Means of Production" from the New York Times. Then answer the following questions:

- 1. Find the two goods or services (or two groups of goods or services) mentioned in the article between which a trade-off must be made in their production.
- 2. What passage indicates that a trade-off exists between the two goods or services? For example, does the article indicate some resources that are in limited supply?
- 3. What evidence is there in the article about the applicability or inapplicability of the law of increasing opportunity cost?
- 4. What passage in the article indicates a possible shift of the production-possibilities curve or a movement along it? (The shift or movement may have occurred already, may be occurring now, or may occur in the future. Or, the author of the article may be implicitly advocating a shift or a movement.)
- 5. What would the production-possibilities curve between the two goods in Question 1 look like? Carefully and neatly draw a production-possibilities curve for the two goods using Figure 1.2. Don't use any numbers. However, be very careful to label both of your axes properly and to draw a production-possibilities curve with the correct shape, showing evidence of the applicability or inapplicability of the law of increasing opportunity costs.

Figure 1.2



6. In your diagram of a production-possibilities curve, in what direction would there be a movement along the curve or in what direction would the curve shift based on the passage in Question 4 above? Draw an arrow to indicate the movement or shift.

#### **Common Errors**

The first statement in each "common error" below is incorrect. Each incorrect statement is followed by a corrected version and an explanation.