

STUDY GUIDE

Parkin

ECONOMICS

David E. Spencer



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Brigham Young University



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TO THE STUDENT

My objective in preparing this study guide to accompany *Economics* by Michael Parkin is to make your introductory economics course more enjoyable and more productive. If that objective is realized, you will develop a deeper understanding of economics and the many economic issues that play such an important role in all our lives. A short-term (but nevertheless important) by-product of this deeper understanding is likely to be a higher grade in the course. A long-term byproduct is an enhanced ability to think carefully and correctly about important economic issues throughout your life.

A study guide, however, is not a substitute for the text. Before you approach a chapter in the study guide, you should carefully read the corresponding chapter in the text. The major purpose of this study guide, then, is to *reinforce* and *deepen* your understanding of economics, not to initiate that understanding. I have tried to keep that purpose sharply in focus as I have prepared each chapter. Each chapter of the study guide contains two parts. The first part contains four sections intended to enhance your individual study effectiveness while the second part consists of several self-test sections. Let's take a look at the basic content of each chapter by discussing each of these sections.

CHAPTER CONTENT

Chapter in Perspective: As students proceed from chapter to chapter through the text, they frequently get bogged down in the detail and lose sight of the broader picture. The purpose of this first section of each study guide chapter is to put each chapter of the text into perspective to indicate how the current chapter relates to preceding and following chapters and to indicate some of the central issues that are examined. It is intended to breathe a little fresh air into the study process.

Learning Objectives: This section repeats the learning objectives from the text. As you work through each chapter of the study guide, it would be a good idea to ask yourself if you have achieved each of these objectives.

Helpful Hints: A major purpose of this section is to help students avoid some common errors. An additional purpose is to highlight or supplement the text's discussion of key concepts.

Key Figures and Tables: Each chapter of the text contains numerous figures and tables but not all are equally important. Some are designated as "key" figures or tables. Each of these is identified and discussed in this section.

Self-Test: The self-test is intended to be a useful review mechanism as well as an excellent way to prepare for a test. It contains five parts, plus an answer section.

Concept Review: This section provides a check of knowledge of the basic terminology and fundamental concepts of each chapter. It is not a test of deep understanding or mastery of analytical skills.

True or False: Each chapter contains approximately 18 to 20 true and false questions covering the material in the chapter. These questions test basic knowledge of chapter concepts as well ability to apply these concepts.

Multiple-Choice: This section contains approximately 18 to 20 multiple-choice questions covering most of the concepts of each chapter. Since most examinations will consist mainly if not exclusively of multiple-choice questions, these questions will provide useful practice. Each chapter contains a variety of questions that examine knowledge of facts, definitions, and concepts as well as ability to apply economic analysis.

Short Answer: Each chapter contains from 6 to 10 short answer questions. These ask about basic concepts and can generally be answered in a few sentences. Avoid the tendency to simply read the questions and think you know the answer. Writing down brief responses will prove to be very beneficial.

Problems: The best way to learn economics is to do problems. Thus each self-test concludes with a collection of several numerical or graphical problems. In many (perhaps most) chapters, this section will be the most challenging of the self-test sections. It is also likely to be the most helpful in deepening your understanding. In many cases, the problems have been designed to teach as much as test. They have been purposely set so as to lead you through the analysis in a natural way. You are strongly urged to work through all problems carefully.

Answers: The self-test is followed by a section that contains the answers to all self-test items. I would recommend that you complete the entire self-test before looking at the answers. Then, when you find a difference between your answer and the correct answer, return to the text chapter to correct or extend your understanding.

SOME FRIENDLY ADVICE

The best way to ensure a good grade in your economics course is to develop a thorough understanding of economics, and that will require effort. There is no effective method short of that. With that in mind, let me offer some advice on how to develop such an understanding and how this study guide can help.

1. *Read the chapter in the text first.* Make a commitment to yourself at the beginning of the course that you will read the relevant chapter *before* you go to class. You may be amazed at how your instructor's ability to teach improves if you come to class prepared. As you read each chapter, note the concepts and issues that seem more difficult, but don't concentrate on these yet. Your initial purpose is to get a general understanding of the concepts and issues.

2. *Read the first four sections of the study guide chapter.* Study the Helpful Hints and Key Figures and Tables sections especially carefully. They are intended first to help you identify which ideas and concepts are relatively more important and then to help you extend and deepen your understanding of them. Hopefully, some of the difficulties you noted in your first reading of the textbook chapter become clearer by this process.

3. *Return to the text* and read the chapter again, but this time for mastery of the detail. Use a pencil and paper to make notes and to work through the analysis of the text. By the end of this experience you should have a thorough understanding of the material and be ready to test yourself.

4. *Complete the Self-Test sections of the study guide.* To test your understanding and to identify areas of weakness, complete the Concept Review, True or False, Multiple Choice, Short Answer, and Problem sections of the Self-Test. Avoid the mistake of thinking that because your test will only contain multiple-choice questions, you will not benefit greatly from completing the Short Answer and Problem sections. Indeed, these may be the most instructive exercises.

As you respond to the Short Answer questions, you will learn more if you will take the time to *actually write* brief responses rather than simply saying to yourself: "I know the answer to that one." The act of attempting to write answers will reveal weaknesses of which you are yet unaware. This is at least as true for working through the Problems section. The problems are generally sequential and intended to guide you step-by-step through some important aspect of economic analysis. In many cases, your deepest learning will take place as you work these problems.

Once you have tested your understanding and identified areas where that understanding might be weak, you should reread the relevant parts of the textbook chapter.

5. *Use your instructor and/or teaching assistants.* When you have questions about any concept, ask someone who can give you appropriate help. Depending on the arrangements at your university, your instructor or the teaching assistants assigned to your class are anxious to respond to your questions and, indeed, expect you to ask them.

6. *Carefully prepare for each exam.* If you have followed the previous five suggestions, you are an unusually wise student and your preparation for the exam will be much less frustrating than for many of your colleagues. Quickly review your lecture notes as well as each chapter in the text paying special attention to the Review sections and to each chapter summary. For each chapter, take another look at the Helpful Hints and Key Figures and Tables sections of the study guide. Also, quickly review the sections of the Self-Test, *except* the Multiple-Choice section. If you used paper and pencil as you previously worked through the Short Answer and Problems sections, your review will likely proceed more quickly. Then, as a final preparation, complete the Multiple-Choice section of the study guide again. This time, however, be sure not only to know why the correct choice is correct, but also to see if you *know why each incorrect choice is incorrect*. If you can do this, you will be very well prepared.

7. Consider forming a study group. A very useful way to learn economics is to discuss the things you are learning with other motivated students. As you discuss concepts and issues, your understanding will deepen and your areas of weakness will become apparent.

As you effectively use the textbook and study guide together, you will not only be well prepared for tests, but, more important in the long-run, you will have developed analytical skills and powers of reasoning that will benefit you throughout your life.

DO YOU HAVE ANY FRIENDLY ADVICE FOR ME?

This study guide has been carefully checked for errors but, no doubt some were not detected. If you discover errors or have other suggestions for ways that the study guide can be improved, please write to me. Send your correspondence to

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Provo, Utah

D.E.S.

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1: WHAT IS ECONOMICS?

CHAPTER IN PERSPECTIVE

Whether we realize it or not (and most of us do), economic issues pervade almost every aspect of our lives. Virtually every choice we make can be considered an economic decision. Almost everything we enjoy (or hate, for that matter) involves economics to one degree or another. Political campaigns seem to be dominated by economic issues. We do not need to be economists to recognize the lurking omnipresence of economics in our lives.

This first chapter introduces the subject of economics by briefly discussing *what* kinds of questions economics tries to answer, *why* these questions are interesting and important, and *how* economists go about attempting to obtain answers. Given its introductory nature, the discussion is necessarily brief and at many points only suggestive. The purpose of the remaining chapters of the text is to expand and illuminate.

LEARNING OBJECTIVES

After studying this chapter, you will be able to:

- State the kinds of questions that economics tries to answer
- Explain why all economic questions and economic activity arise from scarcity
- Explain why scarcity forces people to make choices
- Define opportunity cost
- Describe the function and the working parts of an economy
- Distinguish between positive and normative statements
- Explain what is meant by an economic theory and how economic theories are developed by building and testing economic models

HELPFUL HINTS

1. Though it is introductory, this chapter discusses several important economic concepts. Included among these is one of the most important concepts in all of economics: *opportunity cost*. This fundamental notion is discussed further in Chapter 3, but now is the time to develop a thorough understanding. One way to help establish such an understanding is to explicitly evaluate the opportunity costs of the choices you make in your daily activities. See if you can explain those choices (after the fact) using the concept of opportunity cost.

2. Another fundamental point of this chapter is that economics is a science. It is important for students to understand that, like other sciences, economics seeks to enlarge our understanding of the world by constructing, examining, and testing *economic models*. Such models are highly simplified representations of the real world. Rather than making models less useful, this simplicity actually enhances their usefulness. By selectively abstracting from the less relevant complexity of the real world, economic models allow us to focus more clearly on those factors which are most important for the question under investigation.

Models are frequently compared to maps, which are useful because they "abstract from" real world detail. A map does not indicate every feature of the landscape (e.g., trees, rocks, etc.) but rather offers a simplified view, which is carefully selected according to the purpose of the map.

3. As a general rule, the following perspective will be helpful: The text is not so much about the economy or economic problems; it is about how to think about economic issues.

KEY FIGURE

Figure 1.1 A Picture of the Economy

This figure illustrates the flow of goods and services as well as flows of money in the economy. There are three decision-making sectors (households, firms, and governments) and two groups of markets (goods markets and factor markets). Households supply factors of production to firms through factor markets for which they receive payment of wages, interest, rent, and profits. Firms supply goods and services to households through goods markets for which they receive money payments. Governments collect taxes (money flows) from both households and firms and supply goods and services to both in addition to other benefits (transfer payments) to households and subsidies to firms.

SELF-TEST

CONCEPT REVIEW

1. The fundamental and pervasive fact that gives rise to economic problems is _____. This simply means that human wants _____ the resources available to satisfy them. The inescapable consequence is that people must make _____.
2. When we choose an action, the value of the best forgone alternative is the _____ cost of that action.
3. The process of evaluating the costs and benefits of our choices in order to do the best we can with limited resources is called _____.
4. An economy is a mechanism that determines _____ is produced, _____ it is produced, and _____ it is produced.
5. The three groups of decision makers in the economy are _____,

- _____, and _____.
6. Factors of production are classified under three general headings. The physical and mental resources of human beings are called _____, natural resources are called _____, and manufactured goods used in production (e.g., machines and factories) are called _____.
 7. While all economies must have some way of coordinating choices, there are two fundamental mechanisms. The _____ mechanism relies on the authority of some kind of central planning, while the _____ mechanism relies on the adjustment of _____ in economic markets. A _____ economy has elements of both of these fundamental mechanisms.
 8. An economy that is economically linked with other economies in the world is called _____.
 9. Statements about what *is* are called _____ statements, while those about what *ought* to be are called _____ statements.
 10. The branch of economics that studies the choices of individual households and firms is called _____, while the branch which studies behavior of the economy as a whole is called _____.

TRUE OR FALSE

1. Scarcity is a problem only for capitalist (market) economies.
2. Economics is sometimes called the science of choice.
3. Scarcity can be eliminated through cooperation.
4. The notion of opportunity cost is illustrated by the fact that because Fred studied for his economics exam last night he was unable to see a movie with his friends.
5. Competition is a contest for command over scarce resources.
6. Firms are organizations that produce goods and services by combining resources supplied by households.
7. To economists, capital is the money used by businesses to buy assets.
8. The pair of scissors a barber uses to cut hair is an example of capital as a factor of production.
9. In an economy in which economic activity is coordinated by a command mechanism, the decisions of *what*, *how*, and *for whom* are the result of price adjustment.

- _____ 10. A mixed economy is one in which there is both internal and international trade.
- _____ 11. The U.S. is a pure market economy.
- _____ 12. In economics, a closed economy is one in which there is very limited economic freedom.
- _____ 13. The U.S. is an open economy.
- _____ 14. Careful and systematic observation and measurement are basic components of any science.
- _____ 15. Economics is not a science since it deals with the study of willful human beings and not inanimate objects in nature.
- _____ 16. "An increase in the income tax rate will cause total tax revenue to fall." This is an example of a positive statement.
- _____ 17. Science is silent on positive questions.
- _____ 18. A positive statement is about what *is*, while a normative statement is about what *will be*.
- _____ 19. One of the key assumptions of an economic model is that people make choices which they expect to make them as well-off as possible.
- _____ 20. Economic models are of very limited value in helping us understand the real world because they abstract from the complexity of the real world.
- _____ 21. Microeconomics is concerned with the economy as a whole.
- _____ 22. Macroeconomics includes the study of the causes of inflation.
- _____ 23. Testing an economic model requires comparing its predictions against real world events.

MULTIPLE-CHOICE

- 1. The fact that human wants cannot be fully satisfied with available resources is called the problem of
 - a. opportunity costs.
 - b. scarcity.
 - c. normative economics.
 - d. what to produce.
- 2. The problem of scarcity
 - a. exists only in economies which rely on the market mechanism.
 - b. exists only in economies which rely on the command mechanism.
 - c. exists in all economies.
 - d. means that at least some prices are too high.

3. When the government chooses to use resources to build a dam, those resources are no longer available to build a highway. This illustrates the concept of
 - a. microeconomics.
 - b. macroeconomics.
 - c. opportunity cost.
 - d. optimizing.
4. Sally has the chance to either attend an economics lecture or play tennis. If she chooses to attend the lecture, the value of playing tennis is
 - a. the opportunity cost of attending the lecture.
 - b. greater than the value of the lecture.
 - c. not comparable to the value of the lecture.
 - d. equal to the value of the lecture.
5. The opportunity cost of getting a \$10 haircut is
 - a. the best alternative use of the \$10.
 - b. the best alternative use of the time it takes to get a haircut.
 - c. the best alternative use of both the \$10 and the time it takes to get a haircut.
 - d. the value of \$10 to the barber.
6. Which of the following is an example of capital as a factor of production?
 - a. Money held by General Motors
 - b. A General Motors bond
 - c. An automobile factory owned by General Motors
 - d. All of the above
7. A closed economy is one that
 - a. has strict government control of production.
 - b. has no economic links with other economies
 - c. maintains strict control of its borders.
 - d. is characterized by a dominant agricultural sector.
8. A normative statement is one about
 - a. what is usually the case.
 - b. the assumptions of an economic model.
 - c. what ought to be.
 - d. what is.
9. "The rich face higher income tax rates than the poor" is an example of
 - a. a normative statement.
 - b. a positive statement.
 - c. a negative statement.
 - d. a theoretical statement.
10. An economic model is tested by
 - a. examining the realism of its assumptions.
 - b. comparing its predictions with the facts.
 - c. the Testing Committee of the American Economic Association.
 - d. All of the above

11. Which of the following is NOT a key assumption of an economic model?
 - a. People have preferences.
 - b. People economize.
 - c. People are constrained by a given technology and a fixed amount of resources.
 - d. People's choices are not coordinated.
12. When economists say that people are rational, it means
 - a. they do not make errors of judgement.
 - b. they make the best decision from their perspective.
 - c. they act on complete information.
 - d. they will not later regret any decision made now.
13. The branch of economics that studies the decisions of individual households and firms is called
 - a. macroeconomics.
 - b. microeconomics.
 - c. positive economics.
 - d. normative economics.
14. Which of the following would NOT be considered a macroeconomic topic?
 - a. The reasons for a decline in the price of orange juice
 - b. The cause of recessions
 - c. The effect of the government budget deficit on inflation
 - d. The determination of aggregate income (GNP)

SHORT ANSWER

1. What is meant by scarcity?
2. Why does the existence of scarcity mean that we must make choices?
3. Why will cooperation not eliminate scarcity?
4. What is meant by opportunity cost? What is the opportunity cost of spending two hours studying for an economics exam?
5. Sarah takes five courses each school term. She is considering taking economics as her fifth course this term. If she decides to do so, what is the opportunity cost of taking the economics course?
6. What are the three broad classifications of factors of production? Give two examples of each.
7. Why is the U.S. economy considered to be mixed?
8. List the four key assumptions of an economic model.
9. Is the following statement normative or positive? *Why?* "All college students should take an economics course."
10. How are economic models tested?

PROBLEMS

1. It takes one hour to travel from Boston to New York by airplane and 5 hours by train. Further, suppose that air fare is \$100 and train fare is \$60. Which mode of transportation has the lower opportunity cost for someone who could earn \$5 an hour if they were not traveling. For someone who could earn \$10 an hour? For someone who could earn \$12 an hour?
2. Suppose the government builds and staffs a hospital in order to provide "free" medical care. What is the opportunity cost of the free medical care? Is it free from the perspective of society as a whole?
3. Indicate whether each of the following statements is positive or normative. If it is normative (positive), rewrite it so that it becomes positive (normative).
 - a) "The government ought to reduce the size of the deficit in order to lower interest rates."
 - b) "Government imposition of a tax on tobacco products will reduce their consumption."
4. Suppose we examine a model of plant growth which predicts that, given the amount of water and sunlight, the application of fertilizer stimulates plant growth. How might you test the model?

ANSWERS**CONCEPT REVIEW**

1. scarcity; exceed; choices
2. opportunity
3. optimizing
4. what; how; for whom
5. households; firms; government
6. labor; land; capital
7. command; market; prices; mixed
8. open
9. positive; normative
10. microeconomics; macroeconomics

TRUE OR FALSE

- | | | | |
|------|-------|-------|-------|
| 1. F | 7. F | 13. T | 19. T |
| 2. T | 8. T | 14. T | 20. F |
| 3. F | 9. F | 15. F | 21. F |
| 4. T | 10. F | 16. T | 22. T |
| 5. T | 11. F | 17. F | 23. T |
| 6. T | 12. F | 18. F | |

MULTIPLE-CHOICE

- | | | | |
|------|------|-------|-------|
| 1. b | 5. c | 9. b | 13. b |
| 2. c | 6. c | 10. b | 14. a |
| 3. c | 7. b | 11. d | |
| 4. a | 8. c | 12. b | |

SHORT ANSWER

1. Scarcity is the universal condition that human wants always exceed the resources available to satisfy them.
2. The fact that goods and services are scarce means that individuals cannot have all of everything they want. It is therefore necessary to choose among alternatives.
3. Scarcity is a problem of essentially infinite wants and limited resources. While cooperation is one way to organize our activity as we confront the problem of scarcity, it cannot eliminate it and therefore cannot eliminate economic problems.
4. Opportunity cost is the best forgone alternative (opportunity). The opportunity cost of spending two hours studying for an economics exam is the best alternative activity you would have chosen. This, obviously, will be different for different individuals. It might be attending the opera, watching TV, or sleeping.
5. The opportunity cost of choosing the economics course is the course Sarah would have chosen otherwise. If her *next* choice is a sociology course, then that would be the opportunity cost.
6. *Labor*: the effort and skill of a carpenter, the ability of an actor.
Land: trees, water
Capital: a tractor, a factory building
7. The U. S. economy is a mixed economy because it relies on both the market and command mechanisms. Most coordination is carried out through the market mechanism, but there are many economic decisions which are either made or regulated by the government.
8. 1) People have preferences.
2) People face constraints; a fixed amount of resources and a given technology.
3) People economize.
4) People's choices are coordinated.
9. The given statement, however wise, is normative because it is about what ought to (should) be rather than what is.
10. Economic models are tested by comparing the model's predictions with the facts of the real world. If the predictions of the model are in conflict with those facts, the model is rejected, otherwise we do not reject the model.