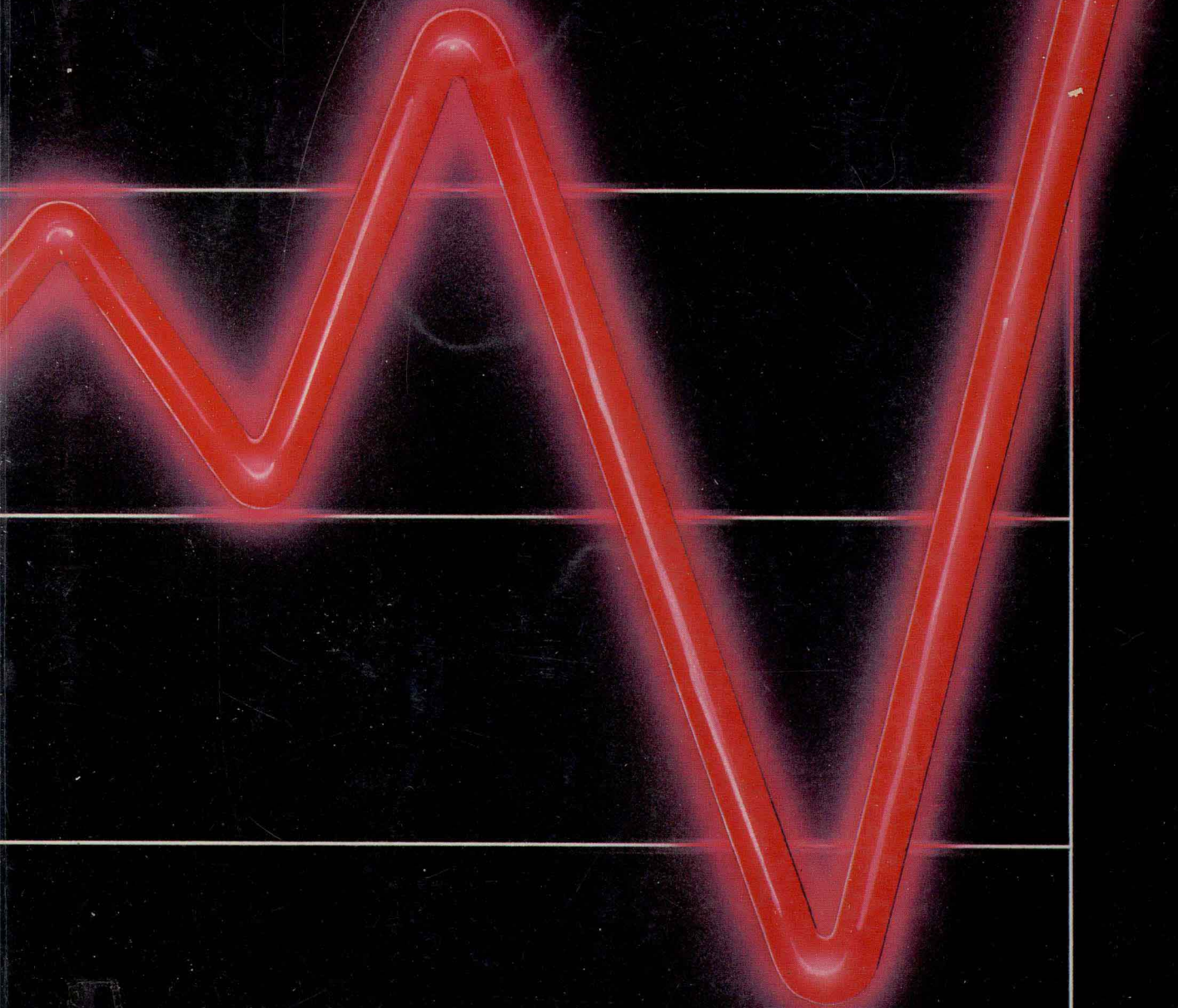


**STUDY GUIDE  
FOR**

**ESSENTIALS OF  
ECONOMICS**

**J.R. CLARK**



**GWARTNEY • STROUP • CLARK**

# **STUDY GUIDE for ESSENTIALS OF ECONOMICS**

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Fairleigh Dickinson University

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# Preface

This *Study Guide* is designed as a valuable support tool for the student using *Essentials of Economics*. It provides several important features that contribute to a good course which cannot be included in the standard textbook, and if used correctly it will improve your understanding of, and ability to apply, economic principles to everyday decision-making.

In order to get the most out of this course it is important that you follow these four steps:

1. **ACTIVELY PARTICIPATE IN THE LEARNING PROCESS.** Active participation implies a great deal more than taking notes in class, memorizing them the night before the exam, and hoping for the best. Active learning requires that you **INTERACT** with the class, the instructor, and the text material. The self-tests in Sections 1 and 2 of each chapter of this *Study Guide* will assist you in this effort. After having read the text material you should review the learning objectives at the end of each chapter and then try to answer the self-test questions in this *Guide*. If you cannot answer most of these questions correctly, the text material should be reviewed further.

2. **SEEK OUT PROMPT ACCURATE FEEDBACK REGARDING WHAT YOU HAVE LEARNED.** Timely feedback reinforces correct concepts and helps to dispel misconceptions. The answers to the self-test questions provided in the *Study Guide* are intended to give you this

type feedback. They should be used responsibly. If you encounter a question to which the correct answer is puzzling, you should discuss the matter with the instructor while the issue is still fresh in your mind. Also, the *Study Guide* should be used regularly as you move through the weekly material. If a significant interval elapses between your reading of the text and working in the *Study Guide*, much of the value of using the *Guide* will be lost. Your regular timely use of it will give you a clear competitive edge over the student who does not use it properly.

3. **LEARN THE RELEVANCE OF THE CONCEPTS.** Relevance is both a motivational force and a guide to application. If you understand the relevance of a particular concept to your everyday life, the material will be learned faster and retained longer. The text and this *Study Guide* are designed to stress the **ECONOMIC WAY OF THINKING**. That is, they teach a method of inquiry that enables you to make not only purely economic decisions but also many other types of decisions that affect your everyday life. The problems and projects sections of this *Study Guide* require that you carefully think through problematic situations and that you reason in an economic manner. You should complete these sections in each chapter while considering how the concepts they present could be transferred to your own decision-making. The seven guideposts to economics at the beginning of the text are also valuable in this regard.

4. **LEARN TO ADDRESS ECONOMIC ISSUES AND POLICIES CRITICALLY.** The Perspectives in Economics section of each chapter in this *Study Guide* presents a provocative point of view on a current issue and suggests criticism. You should review each perspective and consider the discussion questions following it. Having done so, you should be able to offer criticism of your own on the issue. Through this process you will develop critical skills and the ability to verbalize your critical analyses. You should learn to formulate your own economic policies and to support your suggestions with sound economic arguments.

If you follow these four steps, your experience in this economics course may be one of the most valuable one of your life. The 1980's are becoming the "age of the economists." What you learn in this course may well influence your career and your happiness, and perhaps even the future of our national economy. With so much at stake it would seem wise to follow carefully the structured course of action described above.

In closing, a word about evaluation is appropriate. Questions very much like those that appear in the self-tests of this *Study Guide* also appear in the *Instructors' Manual and Test Bank*. Many instructors will draw their exam questions from this source. Although not identical to those in the self-tests, these questions have been designed so that the student who can answer the self-test questions will consistently be able to answer those in the test bank. This enables instructors to offer an incentive to students to use the *Study Guide* and thus to understand more fully the material presented in the text.

## ACKNOWLEDGMENTS

Rick Stroup and Woody Studenmund contributed substantially to this volume in their original collection of Perspectives in Economics. Lisa Knoblock, while a student at Fairleigh Dickinson University, contributed much time, effort, and expertise to the development of the vocabulary and test sections. Mary Ann Duncan provided her outstanding word processing

skills. Rob Greenfield stimulated some of the questions raised in this volume with his usual gadfly sense of economic humor. Finally, the contributions of Si Goodwin, Cynthia Jewett, and Casimir Psujek should be noted. They did an excellent job of converting a rag-tag manuscript into a professional product in an unreasonably short period of time.

J. R. Clark  
December 1981

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## CHAPTER ONE

# The Economic Approach

### SECTION ONE

#### True or False

#### Self-Test

1. People derive utility or satisfaction from consuming tangible goods and services like food and clothing as well as from nontangibles like leisure, prestige, and freedom.
2. Economic goods are all those goods that are available in such supply that consumers can obtain all they desire at a zero price.
3. Scarcity and poverty are really the same thing when you think about them in strictly economic terms.
4. Scarcity comes about because resources are fixed and yet people's wants and needs are unlimited.
5. When the benefits of undertaking a specific action increase or the costs of that action decrease, economics tells us that individuals are more likely to undertake that action.



6. When an individual steals money from his or her employer, the primary effect might be an increase in immediate income but the secondary effect might well be the loss of the person's job and a more permanent reduction in long-term earnings.
7. When you decide how to allocate your time among study, leisure, and working at a job, you are not making an economic choice.
8. Extended government spending is "wrong" for the country. We should do what is "right" and reduce government spending. These are examples of normative economic statements.
9. Scientific method is used in economics to test the validity of positive economic statements.
10. Public goods that are provided by government are not scarce, since you can use things like highways and schools all that you want.

## SECTION TWO

### Multiple Choice

#### Self-Test

1. Which of the following goods is not scarce and not an economic good?
  - a. television comedy
  - b. automobiles
  - c. economics textbooks
  - d. smallpox
2. If I can stand up during an exciting play at a football game, I can see better. Therefore, if everyone stands up during the play, it is obvious that they can all see better. This is an example of:
  - a. the comedy of errors
  - b. the fallacy of composition
  - c. the law of scarcity
  - d. the types of mistakes made by trained economists.
3. Which of the following is a normative economic statement?
  - a. Gasoline costs \$1.45 per gallon.
  - b. There are 100,000 more barrels of oil per day being produced this year than at the same time last year.
  - c. There is too much oil being produced this year.
  - d. It takes approximately 12 days for an oil tanker to cross the Atlantic.
4. Economic incentives affect the behavior of:
  - a. only selfish and greedy people
  - b. altruistic people

- c. selfish and altruistic people
  - d. all human beings.
5. The test of an economic theory is its:
    - a. ability to explain behavior
    - b. ability to predict human behavior
    - c. degree of sophistication
    - d. simplicity.
  6. Some examples of incentives to which people respond are:
    - a. large fines for littering the highways
    - b. tax credits for investing in municipal bonds
    - c. reduced prices for matinee performances of films and theatrical events
    - d. all of the above.
  7. Economic resources are:
    - a. anything that is used to make a profit
    - b. anything that is used to incur an economic loss
    - c. anything that can be used to satisfy a want or need
    - d. none of the above.
  8. The United States is producing over \$1 trillion worth of goods and services each year. Obviously there is no scarcity in the United States. This statement is:
    - a. basically true because we have very little poverty
    - b. basically untrue because poverty will always exist among human beings
    - c. sometimes true when output is high in the United States
    - d. never true because taxes are so high in the United States.
  9. Which of the following is the best example of economizing behavior on the part of the student whose only objective is to get an A in the course?
    - a. taking the optional final exam to improve his grade even though he is already certain of an A
    - b. spending the economics class hour studying for another class because he is already assured of getting an A
    - c. doing outside reading in economics that will not be beneficial for the examination
    - d. spending time attending class and studying after the teacher has informed him that his present grade of B cannot possibly change.
  10. The central message of Adam Smith was that the production and wealth of a nation would be magnified if:
    - a. individuals were left free to act in their own interest
    - b. the government controlled the use of and payment for labor and capital
    - c. most goods were provided free by government

- d. people were really more altruistic and looked after each other's welfare as if it were their own.

### SECTION THREE Vocabulary

#### Self-Test

1. \_\_\_\_\_ is a basic economic concept that indicates that less of a good is readily available than consumers would like.
2. The desire for \_\_\_\_\_, which is a scarce good, exceeds the amount available from Nature.
3. \_\_\_\_\_ is the selection from among alternatives.
4. An input such as land, labor, or capital used to produce economic goods is a \_\_\_\_\_.
5. \_\_\_\_\_ is the ability to choose objectively the option that will yield a specific benefit at the smallest cost possible, and conversely, to choose from among alternatives of equal cost the one that will produce the greatest benefit.
6. The satisfaction expected from a chosen course of action is \_\_\_\_\_.
7. \_\_\_\_\_ is the term used to describe the effects of a small change, usually one unit, in economic activity.
8. \_\_\_\_\_ are the economic consequences of an initial economic change that are not immediately identifiable and are felt only with the passage of time.
9. \_\_\_\_\_ comprises two steps: development of a theory, and testing of that theory to determine its consistency with real-world events.
10. A scientific attempt to determine "what is" among economic relationships is commonly termed \_\_\_\_\_.
11. \_\_\_\_\_ involves judgment about "what ought to be" in economic matters; such views cannot be proven false because they are based on value judgments.
12. The view that what is true for the individual will also be true for the entire group constitutes the \_\_\_\_\_.

SECTION FOUR  
**Problems and Projects**

1. List seven guidelines that are important to the economic way of thinking. Explain in your own words the meaning of each guideline, giving examples when they are appropriate.
2. Exhibit 1 shows the relationship between gas consumption of a new Chevrolet and the number of miles traveled.
  - a. Graph the relationship between miles traveled and gas consumption in the space provided. Measure miles traveled on the horizontal axis (x axis) and gasoline consumption on the vertical axis (y axis). Label the graph clearly.
  - b. Is gasoline consumption related positively or negatively to distance traveled?
  - c. How many miles can be traveled on a gallon of gas? What is the slope of the distance traveled–gasoline consumption line (“curve”)?
3. Height and weight are usually related. Exhibit 2 presents data for a sample of persons. The average weight for persons of different heights is shown.

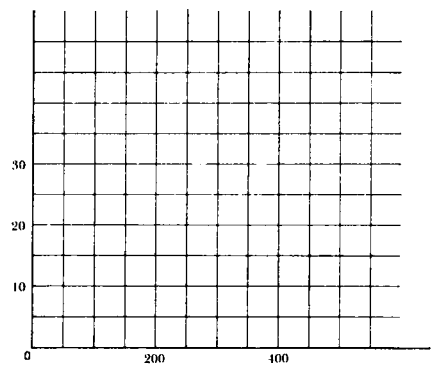
**Exhibit 1**

Total distance traveled (miles)	Amount of gasoline consumed (gallons)
0	0
75	5
150	10
225	15
300	20
375	25
450	30

**Exhibit 2**

Number of persons in class	Height of individual (inches)	Mean weight (pounds)
20	70	160
23	71	168
17	72	176
18	73	182
14	74	186

- a. Graph the height–weight relationship, plotting height on the horizontal axis and weight on the vertical axis.
- b. What is the slope of the line (“curve”) between 70 and 71 inches? Between 73 and 74 inches?



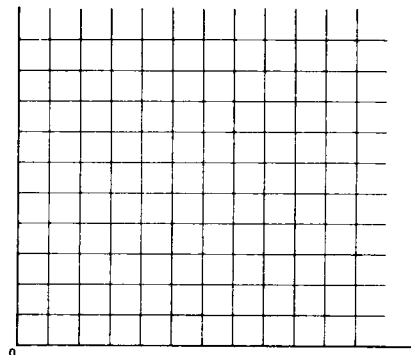
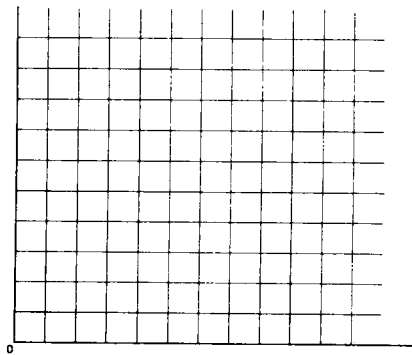
4. Exhibit 3 presents data on national income and consumer spending for the period from 1973 to 1978.

**Exhibit 3**

Year	National income (in billions)	Personal consumption spending (in billions)
1973	\$1065	\$ 810
1974	1136	890
1975	1215	979
1976	1359	1090
1977	1515	1207
1978	1704	1340

Source: *Economic Report of the President*—1979, pages 198 and 204.

a. Graph the relationship in the space provided. Plot national income on the horizontal axis and personal consumption on the vertical axis.



b. Is the relationship between national income and consumption positive or negative?

- c. In 1976–1977, national income increased from \$1359 billion to \$1515 billion—a gain of \$156 billion. How large was the increase in consumption associated with this \$156 billion change in income? What is the slope of the consumption–income relationship over this range?
- d. Is the slope of the consumption–income relationship constant for each year?

## SECTION FIVE

### Perspectives in Economics

#### What Is Seen And What Is Not Seen

By Frederic Bastiat

[This is a digest of a pamphlet first published in July 1850 by the French economist and legislator.]

In the economic sphere an act, a habit, an institution, a law produces not only one effect, but a series of effects. Of these effects, the first alone is immediate; it appears simultaneously with its cause; it is seen. The other effects emerge only subsequently; they are not seen; we are fortunate if we foresee them.

There is only one difference between a bad economist and a good one; the bad economist confines himself to the visible effect; the good economist takes into account both the effect that can be seen and those effects that must be foreseen.

Yet this difference is tremendous; for it almost always happens that when the immediate consequence is favorable, the later consequences are disastrous, and vice versa. Whence it follows that the bad economist pursues a small present good that will be followed by a great evil to come, while the good economist pursues a great good to come, at the risk of a small present evil.

The same thing, of course, is true of health and morals. Often, the sweeter the first fruit of a habit, the more bitter are its later fruits; for example, debauchery, sloth, prodigality. When a man is impressed by the effect that is seen and has not yet learned to discern the effects that are not seen, he indulges in deplorable habits, not only through natural inclination, but deliberately.

#### The Broken Window

Have you ever been witness to the fury of that solid citizen, James Goodfellow, when his incor-

rigible son has happened to break a pane of glass? If you have been present at this spectacle, certainly you must also have observed that the onlookers, even if there are as many as thirty of them, seem with one accord to offer the unfortunate owner the selfsame consolation: "It's an ill wind that blows nobody some good. Such accidents keep industry going. Everybody has to make a living. What would become of the glaziers if no one ever broke a window?"

Now this formula of condolence contains a whole theory that is a good idea for us to expose, *flagrante delicto*, in this very simple case, since it is exactly the same as that which, unfortunately, underlies most of our economic institutions.

Suppose that it will cost six francs to repair the damage. If you mean that the accident gives six francs' worth of encouragement to the aforesaid industry, I agree. I do not contest it in any way; your reasoning is correct. The glazier will come, do his job, receive six francs, congratulate himself, and bless in his heart the careless child. That is what is seen.

But if, by way of deduction, you conclude, as happens only too often, that it is good to break windows, that it helps to circulate money, that it results in encouraging industry in general, I am obliged to cry out: That will never do! Your theory stops at what is seen. It does not take account of what is not seen.

It is not seen that, since our citizen has spent six francs for one thing, he will not be able to spend them for another. It is not seen that if he had not had a windowpane to replace, he would have replaced, for example, his worn-out shoes or added another book to his library. In brief, he would have put his six francs to some use or other for which he will not now have them.

Let us next consider industry in general. The window having been broken, the glass industry gets six francs' worth of encouragement; that is what is seen.

If the window had not been broken, the shoe industry (or some other) would have received six francs' worth of encouragement; that is what is not seen.

And if we were to take into consideration what is not seen, because it is a negative factor, as well as what is seen, because it is a positive factor, we should understand that there is no benefit to industry in general or to national employment as a whole, whether windows are broken or not broken.

Now let us consider James Goodfellow.

On the first hypothesis, that of the broken window, he spends six francs and has, neither more nor less than before, the enjoyment of one window.

On the second, that in which the accident did not happen, he would have spent six francs for new shoes and would have had the enjoyment of a pair of shoes as well as of a window.

Now, if James Goodfellow is part of society, we must conclude that society, considering its labors and its enjoyments, has lost the value of the broken window.

From which, by generalizing, we arrive at this unexpected conclusion: "Society loses the value of objects unnecessarily destroyed," and at this aphorism, which will make the hair of the protectionists stand on end: "To break, to destroy, to dissipate is not to encourage national employment," or more briefly: "Destruction is not profitable."

### **Taxes**

Have you ever heard anyone say: "Taxes are the best investment; they are a life-giving dew. See how many families they keep alive, and follow in imagination their indirect effects on industry; they are infinite, as extensive as life itself."

The advantages that government officials enjoy in drawing their salaries are what is seen. The benefits that result for their suppliers are also what is seen. They are right under your nose.

But the disadvantage that the taxpayers try to free themselves from is what is not seen, and the distress that results from it for the merchants who supply them is something further that is not seen, although it should stand out plainly enough to be seen intellectually.

When a government official spends on his own behalf one hundred sous more, this implies that a

taxpayer spends on his own behalf one hundred sous the less. But the spending of the government official is seen, because it is done; while that of the taxpayer is not seen, because—alas!—he is prevented from doing it.

It is quite true that often, nearly always if you will, the government official renders an equivalent service to James Goodfellow. In this case there is no loss on either side; there is only an exchange. Therefore, my argument is not in any way concerned with useful functions. I say this: If you wish to create a government office, prove its usefulness. Demonstrate that to James Goodfellow it is worth the equivalent of what it costs him by virtue of the services it renders him. But apart from this intrinsic utility, do not cite, as an argument in favor of opening the new bureau, the advantage that it constitutes for the bureaucrat, his family, and those who supply his needs; do not allege that it encourages employment.

When James Goodfellow gives a hundred sous to a government official for a really useful service, this is exactly the same as when he gives a hundred sous to a shoemaker for a pair of shoes. It's a case of give-and-take, and the score is even. But when James Goodfellow hands over a hundred sous to a government official to receive no service for it or even to be subjected to inconveniences, it is as if he were to give his money to a thief. It serves no purpose to say that the official will spend these hundred sous for the great profit of our national industry; the more the thief can do with them, the more James Goodfellow could have done with them if he had not met on his way either the extralegal or the legal parasite.

Let us accustom ourselves, then, not to judge things solely by what is seen, but rather by what is not seen.

### **Theaters And Fine Arts**

Should the state subsidize the arts?

There is certainly a great deal to say on this subject pro and con.

In favor of the system of subsidies, one can say that the arts broaden, elevate, and poetize the soul of a nation; that they draw it away from material preoccupations, giving it a feeling for the beautiful, and thus react favorably on its manners, its customs, its morals, and even on its industry. One can ask where music would be in France without the Theatre-Italien and the Conservatory; dramatic art without the Theatre-Francais; painting and sculpture without our collections and our museums. One

can go further and ask whether, without the centralization and consequently the subsidizing of the fine arts, there would have developed that exquisite taste which is the noble endowment of French labor and sends its products out over the whole world. In the presence of such results would it not be the height of imprudence to renounce this moderate assessment of all the citizens, which, in the last analysis, is what has achieved for them their pre-eminence and their glory in the eyes of Europe?

To these reasons and many others, whose power I do not contest, one can oppose many no less cogent. There is, first of all, one could say, a question of distributive justice. Do the rights of the legislator go so far as to allow him to dip into the wages of the artisan in order to supplement the profits of the artist? M. de Lamartine<sup>1</sup> said: "If you take away the subsidy of a theater, where are you going to stop on this path, and will you not be logically required to do away with your university faculties, your museums, your institutes, your libraries?" One could reply: If you wish to subsidize all that is good and useful, where are you going to stop on that path, and will you not logically be required to set up a civil list for agriculture, industry, commerce, welfare, and education? Furthermore, is it certain that subsidies favor the progress of the arts? It is a question that is far from being resolved, and we see with our own eyes that the theaters that prosper are those that live on their own profits.

But, by an inference as false as it is unjust, do you know what the economists are now accused of? When we oppose subsidies, we are charged with opposing the very thing that it was proposed to subsidize and of being the enemies of all kinds of activity, because we want these activities to be voluntary and to seek their proper reward in

themselves. Thus, if we ask that the state not intervene, by taxation, in religious matters, we are atheists. If we ask that the state not intervene, by taxation, in education, then we hate enlightenment. If we say that the state should not give, by taxation, an artificial value to land or to some branch of industry, then we are the enemies of property and of labor. If we think that the state should not subsidize artists, we are barbarians who judge the arts useless.

I protest with all my power against these inferences. Far from entertaining the absurd thought of abolishing religion, education, property, labor, and the arts when we ask the state to protect the free development of all these types of human activity without keeping them on the payroll at one another's expense, we believe, on the contrary, that all these vital forces of society should develop harmoniously under the influence of liberty and that none of them should become, as we see has happened today, a source of trouble, abuses, tyranny, and disorder.

Our adversaries believe that an activity that is neither subsidized nor regulated is abolished. We believe the contrary. Their faith is in the legislator, not in mankind. Ours is in mankind, not in the legislator.

When it is a question of taxes, gentlemen, prove their usefulness by reasons with some foundation, but not with that lamentable assertion: "Public spending keeps the working class alive." It makes the mistake of covering up a fact that it is essential to know: namely, that public spending is always a substitute for private spending, and that consequently it may well support one worker in place of another but adds nothing to the lot of the working class taken as a whole. Your argument is fashionable, but it is quite absurd, for the reasoning is not correct.

<sup>1</sup>Alphonse Marie Louis de Lamartine (1790-1869), one of the great poets of French romanticism and subsequently a distinguished statesman.

## Discussion

1. Do you think higher taxes will reduce employment in the private sector? Explain. Do you think public service jobs provided by the government and financed by higher taxes will expand total employment? Why or why not?
2. Do you think subsidies to troubled businesses such as Chrysler, Lockheed, and the Penn Central Railroad create jobs? Do you think subsidies to unemployed workers create jobs? Explain.
3. What did Bastiat mean when he said, "The bad economist confines himself to the visible effect; the good economist takes into account both the effect that can be seen and those that must be foreseen."? Do you agree? Can you cite examples to support your position?



