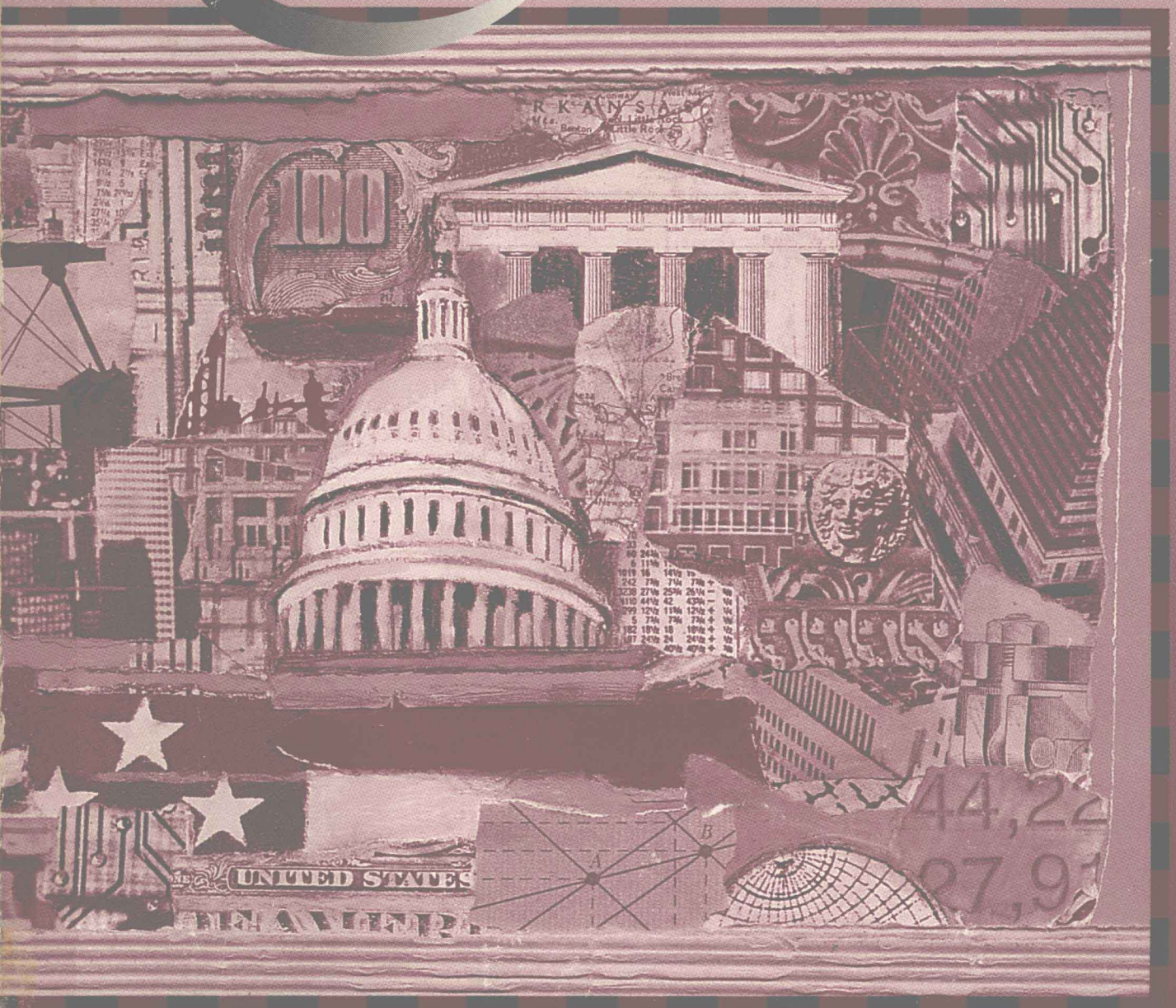
STUDY GUIDE

ECONOMIC PRINCIPLES & POLICIES

SIXTH EDITION



AMACHER & ULBRICH

PREPARED BY PANDO

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SIXTH EDITION

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PREFACE

This *Study Guide* is your guide to the basics of economics; it is meant to be used. You may have read a travel guidebook before you took a vacation. A travel guide points out important things you should see and explains details you might not have known or understood. However, reading the guidebook is not the same thing as taking the trip!

In the same manner, this *Study Guide* will help you get the most out of your study of economics. You should refer to it and work in it often. However, it is not a substitute for reading the text book or going to class; it is a complement to those activities. Students who have done well in introductory economics courses frequently report that they reviewed each chapter in the Study Guide before the material was presented in class. Because the students were already familiar with the material, they were able to ask questions about troublesome parts while the chapter was being discussed in class. If you try this, you should find your grades improving.

Each Chapter of the *Study Guide* is divided into several parts:

Checking In summarizes the important points of each chapter in a few paragraphs. You may want to read this section before you read the chapter in the text, and you will certainly want to read it before your instructor discusses the material in class.

Trying Out the Terms allows you to match the new terms from each chapter with their definitions. Do this as soon as you finish reading the textbook chapter. Understanding all the terms will make the questions and problems easier for you..

Testing Yourself lets you check how well you understand each chapter. You should complete this part after you have mastered the new terms. This section contains true/false statements, multiple choice questions, and problems. Many problems are numerical applications of theories discussed in the textbook, and working with them will make the theories easier to understand. If you have difficulty with any part of this section, ask your instructor to review the material. If you are a member of a study group, your group can use these questions as a review and as a springboard for discussion. You will want to rework this section before your examination.

Taking Another Look presents a new application of or a different way of looking at some of the timely issues discussed in the textbook. This section does not appear in every chapter.

Checking Out gives you a last look at the important topics in each chapter. Use this section as a self-test; if you cannot explain an item, go back and review it in your text or class notes. This section is a good place to begin your review for an examination.

Answers to the Trying Out the Terms and Testing Yourself sections follow Checking Out.

Exercises end each chapter. Your instructor may assign the exercises as homework or as an in-class activity. If they are not assigned, you can complete them as a review. Ask you instructor for a copy of the solutions.

The *Study Guide* was prepared with you in mind. Its purpose is to help you understand and enjoy economics and also to help you earn a better grade. If, in your studies, you find some parts of the Study Guide more helpful than others, or if you come up with new methods of studying that you think will help others, please let us know. We will try to incorporate your suggestions when the Study Guide is revised.

Good luck!

Patricia N. Pando
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STUDY GUIDE FOR

ECONOMIC PRINCIPLES & POLICIES

CONTENTS

CHAPTER 1

ECONOMICS, ECONOMIC METHODS, AND ECONOMIC POLICY

CHECKING IN

You are about to begin the very interesting subject of economics. Economics is the study of the ways in which people and institutions make decisions about producing and consuming goods and services, or how they face the problems caused by scarcity.

The study of economics is generally divided into two parts; both are concerned with these problems of scarcity. Microeconomics considers the interactions of producers and consumers in individual markets. Macroeconomics looks at the economy as a whole; it is concerned with aggregates, or quantities whose values are determined by adding up values for all of the individual markets.

Economics is usually classified as a social science. Economic theory is an abstract way of thinking that allows the development of models and tools that can be used to study social problems.

Resources are finite, but human wants are unlimited. In dealing with the problem of scarcity, people must make choices. They cannot produce everything, so in order to get more of one thing, they must give up something else. The value of the alternative given up is the opportunity cost. The principle of increasing opportunity cost says that the more of one good people have, the greater the amount of other goods they must sacrifice to obtain one more unit of that good.

The importance of opportunity cost is illustrated by the production possibilities curve. This model not only demonstrates the importance of opportunity cost, but also is useful in describing unemployment, economic growth, and the benefits of specialization and exchange.

The approach that most economists take is to make positive statements rather than normative ones. Normative statements suggest what *should* be done. Positive statements say "if this is done, then that will happen," without saying whether it *ought* to be done.

Economists assume that people act out of self-interest: that people always try to make themselves (or their firms or institutions) as well off as possible. Economics stresses how individuals respond to incentives (self-interest), so economists tend to rely on the market to solve many problems that they analyze. They attempt to clarify the options available to the decision maker and consider all possible costs. Economists also consider alternatives or substitutes that are available.

Policy analysis involves five steps: stating the problem, applying the relevant economic model, identifying solutions, evaluating solutions, and choosing and implementing solutions. Most economists' disagreements are over policy choices rather than economic theory. In general, economists agree much more than they disagree.

Economists depend on graphs and algebra to assist in their analysis. The Appendix to this chapter reviews some techniques you will be using in your study of economics.

TRYING OUT THE TERMS

Match each of the following terms with its definition, and then check your answers. If you are having trouble, go back to the text and find the definition there.

Part I

B	1. microeconomics	R	10. resources
O	2. self-interested behavior	C	11. macroeconomics
L	3. testable hypothesis	E	12. aggregates
M	4. model	A	13. economics
K	5. theory	N	14. *ceteris paribus* assumption
Q	6. normative statements	D	15. social science
J	7. increasing opportunity cost	H	16. opportunity cost
G	8. unlimited wants	P	17. positive statements
F	9. scarcity	I	18. production possibilities curve

A. The study of how people and institutions make decisions about production and consumption and how they face the problem of scarcity.

B. The study of individual market interactions, focusing on production and consumption by the individual consumer, firm, or industry.

C. The study of the economy as a whole or of economic aggregates, such as the level of employment and the growth of total output.

D. An academic field that studies the behavior of human beings, individually and in groups, and examines their interactions.

E. Quantities whose values are determined by adding across many markets.

F. The central economic problem that there are not enough resources to produce everything that individuals want.

G. The needs and desires of human beings, which can never be completely satisfied.

H. The value of the other alternatives given up in order to enjoy a particular good or service.

I. A graph that depicts the various combinations of two goods that can be produced in an economy with the available resources.

J. The principle that as production of one good rises, larger and larger sacrifices of another are required.

K. A set of principles that can be used to make inferences about the world.

L. An inference from a theory that can be subjected to real-world testing.

M. A set of assumptions and hypotheses that is a simplified description of reality.

N. The assumption that everything else will remain constant, used for most economic models.

O. A basic assumption of economic theory that individual decision makers do what is best for themselves.

P. A set of propositions about what is, rather than what ought to be.

Q. A set of propositions about what ought to be (also called value judgments).

R. Inputs used to produce goods and services.

Part II

These terms are found in the Appendix to the chapter.

E 1. coordinates

A 2. *y*-axis

G 3. scatter diagram

K 4. tangent line

B 5. *x*-axis

P 6. bar chart

D 7. independent variable

J 8. slope

O 9. pie chart

M 10. minimum

C 11. origin

H 12. positive relationship

N 13. 45° line

I 14. negative relationship

L 15. maximum

E 16. dependent variable

A. The upright line in a coordinate system that shows the values of the dependent variable; the vertical axis.

B. The horizontal line in a coordinate system that shows the values of the independent variable; the horizontal axis.

C. The intersection of the vertical and horizontal axes of a coordinate system, at which the values of both the x-variable and the y-variable are zero.

D. The variable, usually plotted on the horizontal axis, that affects or influences the other variable.

E. The variable, usually plotted on the vertical axis, that is affected or influenced by the other variable.

F. The values of x and y that define the location of a point in a coordinate system.

G. A graph that plots actual pairs of values of two variables to determine whether there appears to be any consistent relationship between them.

H. A relationship between two variables in which an increase in one is associated with an increase in the other and a decrease in one is associated with a decrease in the other.

I. A relationship between two variables in which an increase in the value of one is associated with a decrease in the value of the other.

J. The ratio of the change in the dependent variable (y) to the change in the independent variable (x).

K. A straight line just touching a curve (nonlinear graphic relationship) at a single point. The slope of the line is equal to the slope of the curve at that point.

L. The point on a graph at which the y-variable, or dependent variable, reaches its highest value.

M. The point on the graph at which the y-variable, or dependent variable, reaches its lowest value.

N. A line in the first quadrant, passing through the origin, with a slope of +1, which divides the quadrant in half. If the scales on the axes are the same, the value of the x-variable is equal to the value of the y-variable along this line.

O. A graphic representation in the shape of a pie that expresses actual economic data as parts of a whole. The sizes of the slices of the pie correspond to the percentage shares of the components.

P. A graphic representation that expresses data using columns of different heights.

TESTING YOURSELF

In the next three sections, you will answer questions and work problems that are based on information in the text. Master all of the terms before you begin these sections. Work each section without referring to your notes or the text, and then check your answers.

Part I: True or False

Mark each statement as true or false. Whenever you mark a statement as false, jot down a sentence stating why it is false. Statements 11–14 are based on material in the Appendix.

F 1. The study of economics is concerned with how people react to changing income and prices.

T 2. The level of employment in the economy is a macroeconomic issue.

T 3. Microeconomics is concerned with the interactions of producers and consumers in individual markets.

F 4. Opportunity cost is always measured in monetary terms.

T 5. When some of a society's resources are unemployed, the society is operating at a point inside the production possibilities curve.

T 6. The typical production possibilities curve has a bowed-out shape because of increasing opportunity costs.

F 7. When the Vietnam War began, the United States was operating at a point inside its production possibilities curve.

F 8. The question, "What will happen to the price of corn in a year when there is both a flood and a fall in the price of fertilizer?" observes the *ceteris paribus* assumption.

F 9. An economics teacher tells her class that all transfer payments to veterans should be eliminated. This is an example of a positive economic statement.

N 10. The self-interest assumption holds that all people are selfish.

F 11. If for every increase in x, y increases by 2, 3, or 4 units, the graph of the equation will be a straight line.

T 12. If two variables are negatively (inversely) related, then one variable will increase in value as the other variable decreases.

T 13. The slope of a curve at a particular point is equal to the slope of the straight line tangent to that point.

F 14. If the numbers reported are accurate, statistical reports always give an undistorted view of reality.

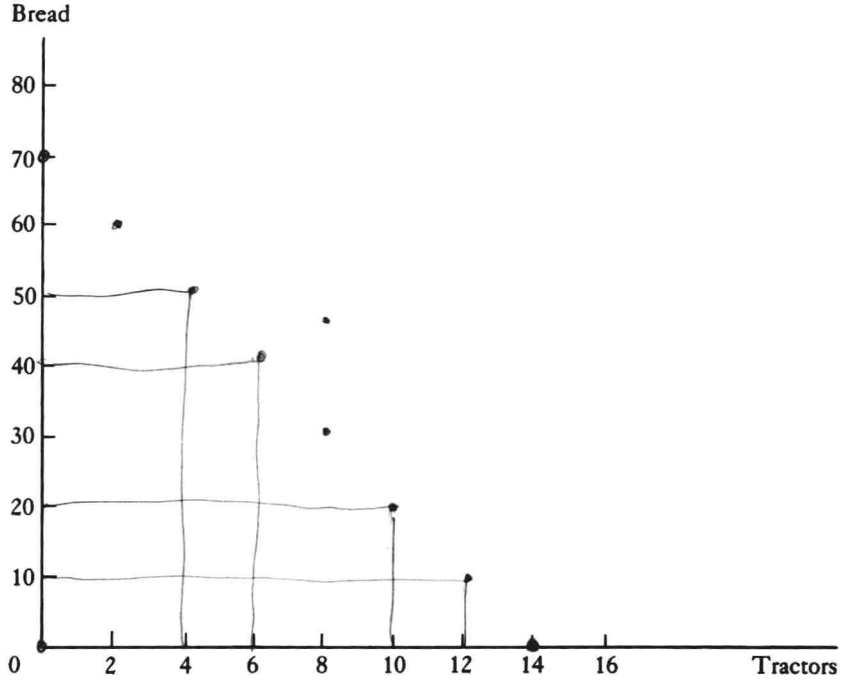
Part II: Problems

Problem 3 is based on the Appendix.

1. You are given the following data for a small country that can produce either bread or tractors.

Bread	Tractors
70	0
60	2
50	4
40	6
30	8
20	10
10	12
0	14

   a. On the graph below, plot the production possibilities curve.

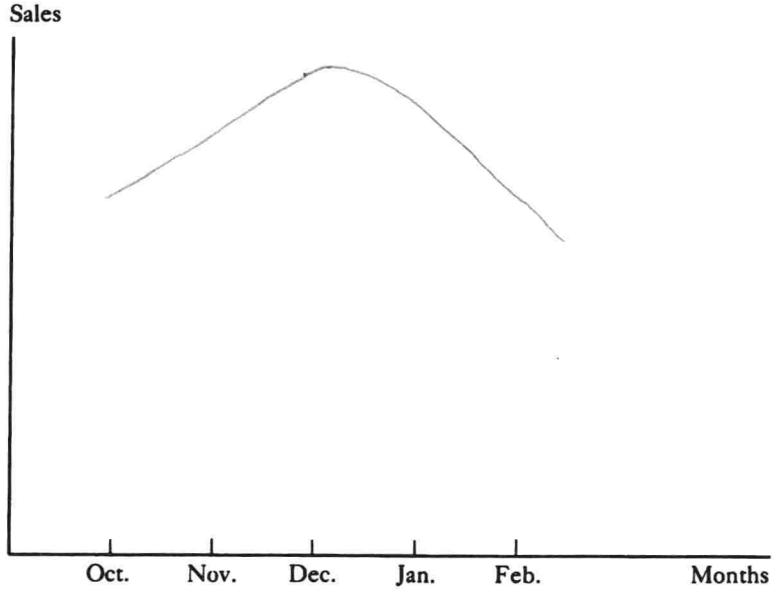


   b. What is the opportunity cost of increasing production of bread from 10 units to 20 units? From 40 units to 50 units?

c. What role do increasing opportunity costs play in this model?

d. On your graph, mark the point representing the production of 45 units of bread and 8 tractors. Will this economy ever produce at this point? Why or why not?

2. On the graph below, plot the sales of a typical retail store during the months of October through February. It is not necessary to use exact values; simply graph the relationship.



3. Consider each of the following relationships:

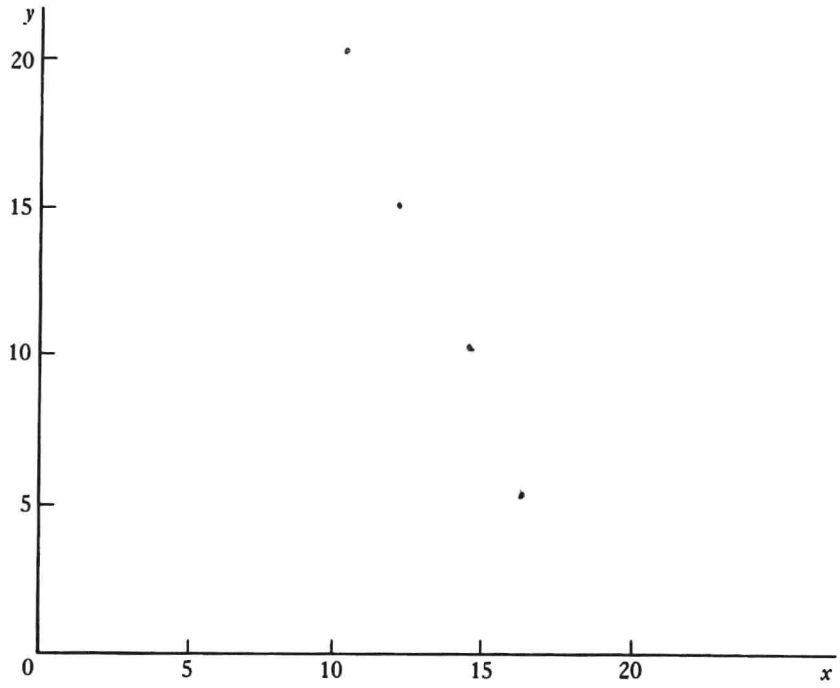
Relationship A		Relationship B		Relationship C	
x	y	x	y	x	y
1	5	10	20	100	90
2	4	12	15	125	100
3	3	14	10	150	110
4	2	16	5	175	120

a. Which of these relationships is/are positive? How can you tell?

C

b. What is the slope of each relationship?

c. In the graph provided below, plot relationship B.



Part III: Multiple Choice

Questions 13–15 are based on the Appendix.

C 1. Economics can be defined as the
   a. study of money and commerce.
   b. science of behavior modification.
   c. study of how people and institutions respond to the problems of scarcity.
   d. study of how labor and product markets are related.

A 2. The study of the overall price level and the levels of unemployment and output is called
   a. macroeconomics.
   b. microeconomics.
   c. decision science.
   d. global economics.

D 3. In microeconomics we would expect to study
   a. the effects of inflation.
   b. the tax policies of the federal government.
   c. changes in the consumer price index.
   d. the determination of the price of corn.