

Economics Honors

Final Exam Review

Content Category	Number of Questions	Test Percentage	Textbook Reference (chapter/page)
Fundamental Economic Concepts	12	26.1	
Scarcity	2		1/6
Opportunity Cost/Trade-off	2		2/25
Productivity	2		3/56
Economic Systems	1		4/73
Economic Institutions & Incentives	4		4/80; 5/101
Exchange, Money & interdependence	1		13/304
Microeconomic Concepts	13	28.3	
Markets & prices	1		8/177
Supply & Demand	4		1/3; 3/47; 3/53;
Competition & Market Structure	3		23/562
Income distribution	2		34/796
Market Failures	1		28/660
Role of Government	2		12/291; 12/293
Macroeconomic Concepts	14	30.4	
Gross National Product	2		6/123; 9/191
Aggregate Supply	1		9/201
Aggregate Demand	2		9/189
Unemployment	1		8/168
Inflation & Deflation	2		8/176
Monetary Policy	3		13/316; 14/338; 10/225
Fiscal Policy	3		12/277; 12/288; 12/293
International Economic Concepts	7	15.2	
Comparative Advantage/barriers to trade	3		2/33; 36/851
Balance of Payments & exchange rates	2		7/147; 7/152
International Growth & Stability	2		34/813; 18/435

Concepts to know...

Pay particular attention to the highlighted terms:

- **"Scarcity,"** in economics, means that society has more wants than it has available resources (or means) to satisfy all those wants. This is a fundamental concept of economics and underlies the idea that ordinarily consumers, businesses, and governments tend to choose the most effective use of limited resources, i.e., they must follow the principle of "economizing." The problem of scarcity is faced continually by every society, whatever the form of its government or economic system.
- The **opportunity costs** of a decision are the choice between the benefits to be received versus those that are forgone.
- The economic **wants** of any society are virtually limitless. In this light, all resources are scarce and every economic system must choose how to make the most efficient use of its scarce resources to produce those goods and services it desires or needs the most.
- Reallocation of resources between two goals indicates that there is a **trade-off** between the two. In order to make such decisions, the economist must weigh the relative benefits each competing goal provides.
- The principle of **diminishing returns** states that as more and more of any one resource is added to a fixed amount of other resources, the increase in total output after some point will become less and less.
- **Specialization** means that businesses/countries tend to produce only those products that they can make most efficiently. Therefore, they must buy other products that are made elsewhere more efficiently. These circumstances tend to increase trade between regions or nations and promote greater **economic interdependence**.
- Active **competition** in the marketplace is essential for the effective operation of a market economy. Competitive markets force business firms to produce the products consumers demand at the lowest prices that will cover costs.
- The characteristics found in the **corporate form of business** that allow it to function include, limited liability, distinct life and multiple shareholders.
- **Profit** is what is left over after all **costs of production** (total costs) are subtracted from total **revenues** (price per unit times the number of units sold). Profit is the fundamental **incentive** for firms or individuals to engage in business in a market economy.
- Relatively high **profits** in a competitive market economy will induce producers to increase output and/or will attract additional producers. Relatively low profits will discourage production of added output and/or will induce some firms to leave an industry that shows low profits. **Barriers to entry** or exit in a particular Industry may inhibit the process of adjusting output to the amount of consumer demand.
- **Collective bargaining** means that workers have the right to join a union and elect representatives to negotiate with their employer about wages, fringe benefits, and the conditions of work for themselves as well as for nonunion workers in similar jobs. A **"closed shop"** means that all workers of a given employer or industry are required to join the union. The **"seniority system"** means that worker rights to, e.g., promotion or vacation, are directly tied to length of employment or duration of union membership, and that if employees are laid off, those with the most seniority are laid off last and are rehired first. **"Right to work"** legislation consists of state laws that mandate the opposite of a closed shop, i.e., workers are not required to join the union of a given industry or employer.

- "**Demand deposits**" make up the major portion of the United States **money supply**, narrowly defined. The remainder consists of currency and coin in the hands of the public, plus NOW accounts and travelers checks issued by non-bank firms. (MI).
- If the prices of the goods and services a person buys rise more than the increase in that person's income, that individual's **purchasing power**, i.e., the ability to buy a given quantity of goods and services, has declined. In other words, "**real income**" has fallen.
- Producers combine **factors of production** in the proportions needed to produce the goods and services they seek to sell. What they seek to produce is determined by what is **demanded** in the marketplace. Thus, the demand for a productive factor is a **derived demand**, depending largely on the market value of the good or service it helps to produce.
- If the total **supply** of a product is increased, the **price** of the product will fall, other things remaining the same.
- Salaries or **wages** earned by most individuals **depend on the demand** for their services relative to the supply of such services.
- "**Perfect competitor**," one of many, many producers in a competitive market. The competitor's output is such a small part of the total output that the producer's decision to sell (or not to sell) will have no effect on the market price of the product. This is an example of a "**price taker**" in a competitive market.
- A **monopolized**, or, in this case, a cartelized industry differs from a competitive one because a **cartel** generally places production or marketing limits on each member and also imposes a minimum price on the product. Moving from a "monopoly" (or cartel) situation to a competitive one should lead to increased output of a product and decreased prices.
- An industry with comparatively few sellers (but more than one) is called an **oligopolistic** industry. Price-setting behavior in such an industry frequently involves **price leadership** by one firm, with the other firms following. Firms in such an industry cannot assume that their price-setting activities will not influence other firms in the industry.
- In a market economy, what businesses can pay workers depends primarily on the contribution the workers make to the salable output of the business. Thus, in a market economy, high wages are fundamentally due to high output per worker, although other factors have some influence.
- Government must provide certain goods, such as national defense, because "**public goods**" are ones to which the "**exclusion principle**" does not apply- i.e., it is difficult or impossible to withhold the benefits of the good or service from those who do not pay. Also, a public good has an additional characteristic: **shared consumption**. In other words, when one person uses a public good, the amount left for other consumers is not reduced.
- A **progressive tax** has a rate of taxation increases as income increases. A **proportional income tax** is one whose rate remains constant as income changes. A **fixed income tax** (if one existed) would presumably have a constant amount of tax, independent of income. Such a tax would be **regressive** (one whose rate falls as income increases). A **value added tax** applies to production or sales, not to income.
- A specific **excise tax** (a tax on a particular product) is most likely to alter the pattern of consumer choices among various products. This is because excise taxes raise the prices of some products relative to others and thereby tend to shift consumer spending away from the higher-priced products.

- **Gross national product** is a measure of the value of a nation's total output of final goods and services in terms of their market prices.
- Economists typically divide the domestic economy into **consumer, business, and government** sectors, the three major sectors that buy the total domestic output of the economy.
- A nation's **maximum GDP** in any given year is set by its total productive resources. The amount of money people have to spend does not necessarily set a maximum on the nation's GDP because the **quantity of money** can be readily increased, or its **velocity** (turnover) can rise, or prices can go down.
- If total spending (**effective demand**) falls short of buying the potential output of a fully employed economy, the **rate of growth** will be slower because the existence of unused productive capacity will inhibit investment in new productive capacity over the years.
- Since consumers spend most of the **after-tax income** they receive, a decline in consumer income will almost certainly reduce consumer spending.
- **Unexpected inflation** benefits people who owe money because after inflation, they pay back less in terms of **real purchasing power** for the amount they have borrowed.
- When commercial banks make loans to businesses or consumers, these funds are in the form of demand deposits at banks, i.e., checking accounts credited to the borrowers. Banks thereby "**create money**." and the nation's **money supply** increases.
- When the Federal Reserve System (FRS) wants to decrease a high rate of inflation, it sells government bonds on the **open market**. The FRS takes in money in exchange for the bonds, which reduces the **reserves** of the banking system and thus the nation's **money supply**. Reducing the **discount rate, reserve requirements, and margin requirements** all tend to increase aggregate demand and thus add to inflation.
- A government reduction of **tax rates** would tend to increase aggregate demand, other things remaining the same. Government reductions in **transfer payments, the budget deficit, or purchases of goods and services** would tend to decrease aggregate demand, at least in the short run.
- If the government reduces taxes, taxpayers are left with more **disposable income** to spend or save. Since consumers are likely to spend most of each additional dollar in disposable income, an increase in consumer spending is likely. This, in turn, would tend to stimulate the economy.
- Government spending without offsetting tax collections normally adds to total spending in the economy because government spending rises without a reduction in private spending. Thus, when there is full employment and total output cannot rise, additional government spending (unless accompanied by matching higher taxes or significant increases in capital flows) will tend to bid up interest rates as the government borrows to finance deficit spending.
- **Comparative advantage** means that a country can benefit by selling those goods it produces at low **opportunity costs** and buying from other nations those goods it would produce at high opportunity costs. The law of comparative advantage simply tells us to **specialize** in what we do best, and trade our output from these relatively efficient industries for goods from other nations that can produce them at relatively lower cost
- **Tariffs** protect domestic industries that might otherwise be eliminated or reduced in size by foreign competition. The workers and owners engaged in such protected industries benefit from the tariff, but the national level of living suffers because all consumers must pay higher prices for the goods produced by the protected industry. Tariffs may increase

employment in domestic industries whose products they protect. But tariffs may decrease demand for exports because other nations gain less foreign exchange with which to buy exports. The most efficient domestic industries will tend to grow with or without tariff protection.

- If **tariffs** are increased in an attempt to correct a balance of trade deficit, we should expect U.S. imports to decrease because of the primary effect of the tariff. However, we should also expect U.S. exports to decrease because other countries will have fewer dollars with which to buy our goods. In addition, foreign nations are quite likely to retaliate against new U.S. tariffs by raising their own.
- **Real income per capita** is the best measure of a nation's standard of living over time for two reasons. One is that measuring income in real terms removes the distorting effects of a changing price level. The other is that total income may be high or low merely because a country has many or few people, e.g., China vs. Norway. Dividing total real income by the population adjusts for such a difference.
- A high **rate of investment** (defined as the accumulation of more machinery, industrial plants, equipment, and the like) characterizes all rapidly growing economies.