

This review sheet is intended to cover everything that could be on the exam; however, it is possible that I will have accidentally left something off. You are still responsible for everything in the chapters covered except anything that I explicitly say you are not responsible for. Therefore, if I left something off of this sheet, it can still be on the exam. There will be no multiple-choice questions. Most of the questions will be like the ones in the homework assignments, and possibly a few definition questions, but I am more likely to ask questions that make you use the definitions rather than recite them. I will probably ask one of the questions from the book at the end of the chapters.

The review session will be Wednesday, 9/28, at 7:30, in the normal room (I hope).

Chapter 1: What are economics, macroeconomics, microeconomics, and wants? Know the difference between positive and normative statements. What is meant by incentives, models, theories, and *ceteris paribus*? What is important about them? From the appendix, know how to plot a straight line, calculate the slope of any line including curves, and know what are direct and inverse relationships.

Chapter 2: What are scarcity, land, labor, physical capital, human capital, entrepreneurship, goods, and services? **“Opportunity costs” is the first of the great ideas in this course that helps this course qualify for fulfilling the Contemporary Society and Institutions requirement for graduation from Bethany College. Therefore, it is one of the most important parts of this course.** What are opportunity costs? How do we see them? Note that opportunity costs are what you *would* have done with the time and resources. What is the PPC (or as I prefer to call it, the PPF)? Why does it take its shape? How does it show the opportunity costs? Where do we see efficiency, inefficiency, and unattainable sections of the graph? What moves it? How does the trade off between current consumption and capital goods affect future output? What are absolute advantage and comparative advantage? What is the law of comparative advantage?

Chapter 3: **“Supply and demand analysis” is the second of the great ideas in this course that help this course qualify for fulfilling the Contemporary Society and Institutions requirement for graduation. Therefore, it is one of the most important parts of this course.** What determines demand? What is the “law of demand”? What do “demand schedule” (a.k.a. table) and “demand curve” represent? What moves the demand curve and what causes movements along the curve? Ignore inferior goods. Answer the above questions for supply. *Note that one of the two most common errors students make on questions is to get confused between movements along a curve and movements of a curve. Price changes cause movements along the curve.* Since the list of things that move supply and the list of things that move demand are almost mutually exclusive (excluding expected prices), you should almost never move both curves. Move one and move along the other one. One note the costs of production include the opportunity costs of producing another good. We called this the price of a substitute in production. For example, if the price of another good that they could produce goes up, then the cost of resources used to produce both go up and that reduces supply of the good you are analyzing. This is one way that the costs of inputs can go up. Also, a change in the selling price of a complement in production will encourage or discourage production of the good, thus will move supply. A complement in production is something that you produce with it. *The other error common to students in this course, is to move the supply curve the wrong way. Note that because the graph has the dependent variable on the horizontal axis, it moves right and left.* Know what equilibrium is and how it is achieved. What are shortages and surpluses?

Chapter 4: What is a price system? Ignore voluntary exchange and terms of exchange. Like most things we skip in these early chapters, they are important for microeconomics but not for macroeconomics. Be able to show movements of supply and demand on the same diagram. If you do not draw both supply and demand, then I will take off points. Also, label all axes and lines. How do we ration goods? What are other methods of rationing? What are the economic effects of price ceilings, price floors, taxes, and quotas. Be able to show them on the supply and demand graph. Use the graphs to explain the problems they cause, how those problems are solved without government action, and what the government can do to relieve those problems.

Chapter 5: What are the following terms and why are they an argument for government intervention in markets? Negative externalities, positive externalities, public goods, merit goods, demerit goods, and inequitable distribution of income. For each of them, explain how the government can partially solve the problems. Why are free riders a problem? What are marginal tax rate, average tax rate, and tax bracket? How can we tell if a tax is progressive, regressive, or proportional? Do not worry about capital gains, capital loss, double taxation, retained earnings, or corporate taxes. Know what tax incidence is, and how to estimate it from a graph. Do not worry about how much government revenue comes from each source, or how it is spent.

Chapter 6: What is the tax base? How can increasing a tax result in less revenue? What are sales, excise, ad valorem, specific (unit) taxes? What is the Laffer Curve? What are Medicare and Social Security? What are their effects on the economy? What is the problem with Social Security? What are some of the proposals for solving the problem? I am most likely to give you a proposal for a solution and ask you how it would work, and whether or not you would implement my proposal.

Chapter 7: What are, and how do we calculate, the unemployment rate, labor force participation rate, and inflation rate? What are stocks and flows? How do they relate to unemployment rates? Know how to classify people by the reason they are unemployed, i.e., laid off, job leaver, etc. Know how to tell who is in which category of unemployment, i.e., frictional, structural, seasonal, and cyclical. What is the natural rate of unemployment and full employment? What are the other costs of unemployment besides lowered production? How do we calculate CPI, PPI, and GDP deflator? Why does it matter if inflation is anticipated

or unanticipated? What are the costs of unanticipated and anticipated inflation? (I added shoe leather costs.) Note that if inflation is expected to be 10% and it ends up being 7%, we had unexpected deflation of 3% and that hurts borrowers. Know what an expansion (a.k.a. boom), contraction, recession, depression, trough, and peak are. What is a leading indicator?

This is the non-graded assignment #3A that will be gone over with assignment #3.

1) (20 points each) For each of the solutions to the Social Security problem, explain how that would reduce the problem. Then explain whether or not you would use that solution. Explain your logic.

- A) Eliminate the payroll cap.
- B) Cut benefits

2) (20 points) Given the articles below and given what is in the book, do you feel that Social Security is a major problem? Why or why not?

3) (10 points) What is wrong with the argument, when inflation is higher, people cannot afford as much. Therefore, everybody is hurt by the fully anticipated inflation.

4) (10 points each) Are these people unemployed? If yes, then explain which category of unemployment and why you chose that category. If no, then explain why not.

- A) A Bethany graduate decides to plan their wedding rather than look for a job. (I know somebody who did this.)
- B) Steel workers are laid off when a plant closes.

5) (10 points) What are some of the additional costs of high unemployment other than lowered output.

The three "articles" below were found on CNNFN.com at:

http://money.cnn.com/2005/01/13/retirement/straight_dope/index.htm

Half truth/exaggeration: The system is going bankrupt.

The system is not going bankrupt. If you define "bankrupt" as not being able to pay your obligations in full, then you might argue Social Security will be bankrupt come 2042, using projections from the Social Security trustees, or 2052, using estimates from the Congressional Budget Office. That's when they project the system will have exhausted its surplus, which it will begin tapping in 2018 when there is less revenue than needed to cover promised benefits. By that logic, though, you also might argue that the U.S. government - with its roughly half-trillion-dollar deficit - is or will be bankrupt.

Some people have the impression that "bankrupt" means penniless. A full 50 percent of non-retired respondents in a recent USA Today/CNN/Gallup poll said they didn't think Social Security would be able to pay them a benefit when they retire. Not true, according to government estimates. The system still will be taking in enough revenue to cover 75 percent to 80 percent of what is currently promised. What's more, even if benefits were reduced to that level, they still would be higher in today's dollars than what current retirees are getting, according to CBO estimates.

Half-truth: The system faces an \$11 trillion shortfall.

\$11 trillion is the number President Bush often uses to illustrate why he considers the system to be in crisis. It is based on projections from the 2004 Social Security Trustees report, a measure in today's dollars of the projected shortfall over an infinite time horizon. (The actual number in the report was \$10.4 trillion.)

So what's the problem? A shortfall measured over an infinite time horizon has limited value to policymakers, according to the nonpartisan American Academy of Actuaries. The health of Social Security is typically measured over 75 years. (The estimated shortfall over 75 years is \$3.7 trillion.)

"Many observers question the reliability or usefulness of calculating Social Security's unfunded obligation over 75 years. Calculations over an infinite period are even less reliable," an Academy report noted.

A more digestible way to express long-term shortfalls is as a percentage of taxable payroll. That's the portion of your wages paid into the system. Currently, it's 12.4 percent -- half paid by you and half paid by your employer. Using assumptions made by the Social Security trustees, to bring the system into actuarial balance over the next 75 years, the payroll tax would need to increase today by 1.89 percentage points, to 14.29 percent. Over the infinite time horizon, it would need to increase by 3.5 percentage points, to 15.9 percent.

Half-truths: There is a surplus. There isn't a surplus.

Here's what we know: Social Security has collected more than it has paid out for 20 years. The excess money has been loaned to the U.S. Treasury in exchange for special-issue Treasury bonds. Those who deride the notion of the "surplus" refer to such bonds as nothing more than pieces of paper in a drawer.

Here are two of their complaints: 1) the money lent to the U.S. Treasury has already been spent on things other than Social Security; and 2) paying back the money means the government will have to borrow more money, raise taxes, cut spending elsewhere or reduce benefits.

Those who argue the surplus is very real note that the special Treasury bonds are backed by the full faith and credit of the U.S. government. So unless the government defaults on its debt -- which it has never done and is not likely to do -- it will honor its obligations to Social Security when the system needs to redeem those bonds in order to continue paying benefits in full.