Answers to Selected Critical Analysis Questions
CHAPTER 1: THE ECONOMIC APPROACH

2. Production of scarce goods always involves a cost; there are no free lunches. When the government provides goods without charge to consumers, other citizens (taxpayers) will bear the cost of their provision. Thus, provision by the government affects how the costs will be covered, not whether they are incurred.

4. For most taxpayers, the change will reduce the after-tax cost of raising children. Other things being constant, one would predict an increase in the birthrate.

5. False. Intentions do not change the effect of the policy. If the policy runs counter to sound economics, it will lead to a counterproductive outcome even if that was not the intention of the policy. Bad policies are often advocated by people with good intentions.

7. Raising the price of new cars by requiring safety devices, which customers would not have purchased if given the choice, slows the rate of sales for new cars. Thus, the older, less safe cars are driven longer, partially offsetting the safety advantage provided by the newer, safer cars. Also, drivers act a bit differently—they may take more risks—when they believe the safety devices will provide protection should they have an accident. In fact, economist Gordon Tullock says that the greatest safety device of all might be a dagger built into the center of the steering wheel, pointed directly at the driver’s chest!

8. Money has nothing to do with whether an individual is economizing. Any time a person chooses, in an attempt to achieve a goal, he or she is economizing.

9. Positive economics can help one better understand the likely effects of alternative policies. This will help one choose alternatives that are less likely to lead to disappointing results.

10. Association is not causation. It is likely that a large lead, near the end of the game, caused the third team to play more, rather than the third team causing the lead.

14. This is a question that highlights the importance of marginal analysis. In responding to the question, think about the following. After pollution has already been reduced substantially, how much will it cost to reduce it still more? If the quality of air and water were already high, how much gain would result from still less pollution?

CHAPTER 2: SOME TOOLS OF THE ECONOMIST

2. This is an opportunity cost question. Even though the productivity of brush painters has changed only slightly, rising productivity in other areas has led to higher wages in other occupations, thereby increasing the opportunity cost of being a house painter. Because people would not supply house painting services unless they were able to meet their opportunity costs, higher wages are necessary to attract house painters from competitive (alternative) lines of work.

4. The statement reflects the view that “exchange is a zero sum game.” This view is false. No private business can force customers to buy. Consumers purchase various goods and services from businesses because they gain by doing so. If they did not gain, they would not continue to purchase items from a business. Similarly, the business firms also gain from their production and sale activities. Mutual gain provides the foundation for voluntary exchange, including that between business firms and their customers.

8. Yes. This question highlights the incentive of individuals to conserve for the future when they have private ownership rights. The market value of the land will increase in anticipation of the future harvest as the trees grow and the expected day of harvest grows closer. Thus, with transferable private property, the tree farmer will be able to capture the value added by his planting and holding the trees for a few years, even if the actual harvest does not take place until well after his death.
9. In general, it sanctions all forms of competition except for the use of violence (or the threat of violence), theft, or fraud.

11. If consumer demand for beef fell, the profitability of cattle herding would fall as well. Many cattle farmers would let their cattle herds dwindle and quit keeping cattle altogether. The result would be a smaller population of cattle, not a larger one. Because cattle are privately owned, an increase in their value in human consumption results in more cattle being kept, whereas a decrease would result in fewer cattle. To “save the cows,” you should eat more beef!

12. Those who get tickets at the lower price gain, whereas those who are prevented from offering a higher price to ticket holders may not get a ticket even though both the prospective buyer and some ticket holders would have gained from the exchange at the higher price. Ticket holders may simply break the law or may sell at the regulated price only to buyers willing to provide them with other favors. Price controls, if they are effective, always reduce the gains from trade.

17. The opportunity cost of those individuals will rise, and they will likely consume less leisure.

CHAPTER 3: SUPPLY, DEMAND, AND THE MARKET PROCESS

1. Choices (a) and (b) would increase the demand for beef; (c) and (d) would affect primarily the supply of beef, rather than the demand; (e) leads to a change in quantity demanded, not a change in demand.

4. Prices reflect marginal value, not total value. The marginal value of a good is the maximum amount a consumer would be willing to pay for a specific unit. The height of the demand curve reflects the value that consumers place on each unit. The total value is the total benefit consumers derive from all units consumed. The area under the demand curve for the number of units consumed reflects the total value. Water provides an example of a good with high total value but low marginal value. With regard to the last question, are there more nurses or professional wrestlers?

8. Neither markets nor the political process leaves the determination of winners and losers to chance. Under market organization, business winners and losers are determined by the decentralized choices of millions of consumers who use their dollar votes to reward firms that provide preferred goods at a low cost and penalize others who fail to do so. Under political decision making, the winners and losers are determined by political officials who use taxes, subsidies, regulations, and mandates to favor some businesses and penalize others.

10. a. Profitable production increases the value of resources owned by people and leads to mutual gain for resource suppliers, consumers, and entrepreneurs.

     b. Losses reduce the value of resources, which reduces the well-being of at least some people. There is no conflict.

12. The supply curve is constructed under the assumption that other things are held constant. A reduction in the supply of oranges such as would occur under adverse weather conditions would lead to both a higher price and smaller total quantity supplied. This is perfectly consistent with economic theory.

14. Questions for thought: What happened to the cost of producing calculators during the period? How would this affect the supply curve and price of the calculators?

17. Business firms do have a strong incentive to serve the interest of consumers, but this is not what motivates them. Instead, they are motivated by self-interest and the pursuit of income, but they must provide consumers with a quality product if they are going to be successful. Good intentions are not required for people to engage in actions that are helpful to others.
CHAPTER 4: SUPPLY AND DEMAND: APPLICATIONS AND EXTENSIONS

1. An increase in demand for housing will also increase the demand for the resources required for its production, including the services of carpenters, plumbers, and electricians. This will lead to higher wages and an increase in employment for people in these groups.

4. Agreement of both buyer and seller is required for an exchange. Price ceilings push prices below equilibrium and thereby reduce the quantity sellers are willing to offer. Price floors push prices above equilibrium and thereby reduce the quantity consumers wish to buy. Both decrease the actual quantity traded in the market.

6.  a. Decreases; b. Increases; c. Decreases; d. Increases

11. The deadweight loss is the loss of the potential gains of buyers and sellers emanating from trades that are squeezed out by the tax. It is an excess burden because even though the exchanges that are squeezed out by the tax impose a cost on buyers and sellers, they do not generate tax revenue (because the trades do not take place).

14. The employment level of low-skilled workers with large families would decline. Some would attempt to conceal the presence of their large family in order to get a job.

16. No. As the tax rate approaches the revenue maximum point, the higher rates substantially reduce the number of trades that take place. This is why the higher rates do not raise much additional revenue. As rates increase toward the revenue maximum point, the lost gains from trade are large and the additions to revenue are small. Thus, rates in this range are highly inefficient.

17.  a. The quantity of cigarettes sold legally will decline sharply. The evidence is consistent with this view. After the tax hike was instituted, the number of cigarette-tax stamps issued by the city of New York fell by approximately 50 percent.
   b. Because the quantity of cigarettes sold legally in New York City will decline sharply, the revenues raised from the tax may actually decline.
   c. Internet purchases will increase. Approximately 80 percent of the cigarettes sold through the Internet are from Indian reservations, which are exempt from state sales tax.
   d. The incidence of smoking by New Yorkers may not decline very much because there are good substitutes available for cigarettes purchased in New York City, namely cigarettes purchased through the Internet or in states with a lower cigarette tax. Thus, the cost of smoking for New Yorkers may not rise very much. Predictably, the tax will lead to a sharp increase in both the legal purchase and illegal smuggling of cigarettes into New York City from localities (such as Virginia and North Carolina) that impose a much lower tax on cigarettes.

CHAPTER 5: DIFFICULT CASES FOR THE MARKET AND THE ROLE OF GOVERNMENT

1. When payment is not demanded for services, potential customers have a strong incentive to attempt a “free ride.” However, when the number of nonpaying customers becomes such that the sales revenues of sellers are diminished (and in some cases eliminated), the sellers’ incentive to supply the good is thereby reduced (or eliminated).

4. The antimissile system is a public good for the residents of Washington, D.C. Strictly speaking, none of the other items is a public good because each could be provided to some consumers (paying customers, for example) without being provided to others.
9. By reducing output below the efficient level, sellers of toasters would no longer produce or exchange some units of the good, despite the fact that the consumers value the marginal units more than it costs to produce them.

11. A public good reflects the characteristics of the good, not the sector in which it is provided. Elementary education is not a public good because it is relatively easy to exclude nonpaying customers and establish a one-to-one link between payment for and receipt of the good.

14. A government intervention would be efficient if the benefits from the intervention exceeded the cost of the intervention. All opportunity costs (such as tax money required, resources utilized, and deadweight losses) would need to be considered in the comparison. A government intervention would be considered inefficient if the costs exceeded the benefits.

CHAPTER 6: THE ECONOMICS OF COLLECTIVE DECISION MAKING

2. Corporate officers, although they surely care about the next few months and the profits during that time, also care about the value of the firm and its stock price. If the stock price rises sufficiently in the next few months—as it will if investors believe that current investments in future-oriented projects (planting new trees, for example) are sound—then the officers will find their jobs secure even if current profits do not look good. Rights to the profits from those (future) trees are salable now in the form of the corporation’s stock. There is no such mechanism to make the distant fruits of today’s investments available to the political entrepreneurs who might otherwise fight for the future-oriented project. Only if the project appeals to today’s voters, and only if they are willing to pay today for tomorrow’s benefits, will the program be a political success. In any case, the wealth of the political official is not directly enhanced by his or her successful fight for the project.

4. The problem is not so much that the “wrong guys” won the last election as it is the incentive structure confronted by political decision makers. Even if the “right people” were elected, they would be unlikely to improve the efficiency of government, at least not very much, given the strong incentive to support special interest and shortsighted policies and the weak incentives for operational efficiency when decisions are made by the political process.

6. True. Because each individual computer customer both decides the issue (what computer, if any, will be purchased) and bears the consequences of a mistaken choice, each has a strong incentive to acquire information needed to make a wise choice. In contrast, each voter recognizes that one vote, even if mistaken, will not decide the congressional election. Thus, a voter has little incentive to search for information to make a better-informed choice.

8. It is difficult for the voter to know what a candidate will do once elected, and the rationally ignorant voter is usually unwilling to spend the time and effort required to understand issues because the probability that any single vote will decide the issue is exceedingly small. Special-interest voters, in contrast, will know which candidate has promised them the most on their issue. Also, the candidate who is both competent and prepared to ignore special interests will have a hard time getting these facts to voters without financial support from special-interest groups.

   Each voter has an incentive to be a “free rider” on the “good government” issue. Interestingly, controlling government on behalf of society as a whole is a public good. As in the case of other public goods, there is a tendency for too little of it to be supplied.

10. No. The government is merely an alternative form of organization. Government organization does not permit us to escape either scarcity or competition. It merely affects the nature of the competition. Political competition (for example, voting, lobbying, political contributions, and politically determined budgets) replaces market competition. Neither is there any reason to believe that government organization modifies the importance of personal self-interest.

12. When the welfare of a special-interest group conflicts with that of a widely dispersed, unorganized majority, the legislative political process can reasonably be expected to work to the benefit of the special interest.
The presence of the sugar price supports and highly restrictive import quotas reflect the special-interest nature of the issue. Even though there are far more sugar consumers than growers, politicians apparently gain more by supporting the sugar growers and soliciting their political contributions than by representing the interests of consumers. Government action in this area has almost certainly reduced the income levels and living standards of Americans.

**CHAPTER 7: TAKING THE NATION’S ECONOMIC PULSE**

1. Choices (a), (c), (f), (g), and (h) will exert no effect on GDP; (b) and (d) will increase GDP by the amount of the expenditure; and (e) will increase GDP by $250 (the commission on the transaction).

3. Because the furniture was produced last year, the sale does not affect GDP this year. It reduces inventory investment by $100,000 and increases consumption by $100,000, leaving GDP unchanged.

5. The reliability of GDP comparisons over long periods of time is reduced because the leisure and human costs may change substantially between the two years, and because the types of goods available for consumption during the two years may be vastly different.

7. $8.10

9.  
   a. $1,000;  
   b. $600;  
   c. $200;  
   d. 0;  
   e. $20,000

11.  
   a. False. Inventory investment indicates whether the holdings of unsold goods are rising or falling. A negative inventory investment merely indicates that there was a reduction in the size of inventories during the period.
   
   b. False. If gross investment is less than the depreciation of capital goods during the period, net investment would be negative. Net investment in the United States was negative for several years during the Great Depression of the 1930s.
   
   c. Not necessarily. Rather, it may be the result of an increase in prices, population, or hours worked.

12. Neither the receipts nor the expenditures on payouts would count toward GDP because they are merely transfers—they do not involve production. However, expenditures on operations, administration, and government-provided goods and services from lottery proceeds would add to GDP.

14.  
   a. 0;  
   b. 0;  
   c. $300;  
   d. $500;  
   e. $300;  
   f. 0;  
   g. 0;  
   h. 0

16.  
   a. $2,506.7 billion;  
   b. $3,776.4 billion;  
   c. 54.0;  
   d. $5,803.8 billion;  
   e. 108.6;  
   f. $9,817 billion; and  
   g. $11,654.4 billion

**CHAPTER 8: ECONOMIC FLUCTUATIONS, UNEMPLOYMENT, AND INFLATION**

1. Job seekers do not know which employers will offer them the more attractive jobs. They find out by searching. Job search is “profitable” and consistent with economic efficiency as long as the marginal gain from search exceeds the marginal cost of searching. The job search process will lead to a better match between the skills of employees and the requirements of the available jobs.

2. Individuals (e) and (f) would be classified as employed; (a), (b), and (c) would be classified as unemployed; (d) is not in the labor force.

6. When the actual unemployment rate is equal to the natural rate of unemployment, cyclical unemployment is absent and potential GDP is at its sustainable rate.

7.  
   a. 60 percent;  
   b. 8.3 percent;  
   c. 55 percent

8. No. It means that there were no jobs available at wage rates acceptable to the potential workers who were unemployed. Thus, they continued to search for more attractive opportunities.
10.  a. $646,552; $925,926; $581,395; $417,537; $400,000; b. 1940; c. The real salary rose because the price level fell between 1920 and 1940.

13. The wages people earn are also prices (prices for labor services) and, like other prices, they usually rise as the general level of prices increases. The statement ignores this factor. It implicitly assumes that money wages are unaffected by inflation—that they would have increased by the same amount (6 percent) even if prices would have been stable. Generally, this will not be the case.

CHAPTER 9: AN INTRODUCTION TO BASIC MACROECONOMIC MARKETS

4. If the inflation rate unexpectedly falls from 3 percent to zero, the real wages of union members will rise. If other unions have similar contracts, the unemployment rate will increase because employment costs have risen relative to product prices. Profit margins will be cut, and producers will respond by reducing output and laying off workers. In contrast, if the inflation rate rises to 8 percent, profit margins will improve, producers will expand their output, and the unemployment rate will decline.

6. An increase in the real interest rate will make it more attractive for foreigners to purchase bonds and make other investments in the United States. As a result, there will be an increase in the inflow of capital from abroad.

8. When the price level is higher than decision makers had anticipated, real wages will be lower and the level of employment higher than would have been the case if the price level had been anticipated accurately. Profit margins will increase; the actual rate of unemployment will fall below the natural rate. The high current rate of output will not be sustainable because real wages will rise as there is opportunity to renegotiate existing contracts.

10. They are all equal.

12. $10,000; $20,000

13. Inversely; an increase in interest rates is the same thing as a reduction in bond prices.

16. a. 5,700;
b. No, because the actual price level will be 110, higher than what was anticipated.
c. Actual unemployment will be less than the natural rate because the unexpected high level of prices will improve profit margins, reduce real wage rates, and cause the firms to expand output in the short run.

CHAPTER 10: DYNAMIC CHANGE, ECONOMIC FLUCTUATIONS, AND THE AD-AS MODEL

1. Choice (a) would decrease $AD$; (b), (c), and (d) would increase it; and (e) would leave it unchanged. For the “why” part of the question, see the Factors That Shift Aggregate Demand section at the beginning of the chapter.

2. Choices (a), (b), (c), and (d) will reduce $SRAS$; (e) will increase it.

6. At the lower-than-expected inflation rate, real wages (and costs) will increase relative to product prices. This will squeeze profit margins and lead to reductions in output and employment, causing the unemployment rate to rise.

8. Tightness in resource markets will result in rising resource prices relative to product prices, causing the $SRAS$ to shift to the left. Profit margins will decline, output rates will fall, and long-run equilibrium will be restored at a higher price level. The above-normal output cannot be maintained because it reflects input prices that people would not have agreed to and output decisions they would not have chosen if they had anticipated the current price level (and rate of inflation). Once they have a chance to correct these mistakes, they do so; output returns to the economy’s long-run potential.

10. The increase in demand for exports will increase aggregate demand. In the short run, this unanticipated expansion in demand will tend to increase output and employment while exerting modest upward pressure on the price level. In the long run, the primary impact will be a higher price level, with no change in output and
employment.

13. The assets destroyed (such as World Trade Center and a portion of the Pentagon) by the attack reduced the productive assets of the United States and thereby adversely affected potential real output. However, these assets were a relatively small share, less than 0.01 percent, of U.S. capital assets. Thus, the direct effect on potential output was small. But there were also indirect effects, such as increased expenditures on national defense and domestic security. The opportunity cost of these indirect effects reduced the future potential output of consumer goods and thereby adversely affected the future living standard of Americans. These indirect effects may well be larger than the effect of the assets destroyed.

CHAPTER 11: FISCAL POLICY, HISTORICAL PERSPECTIVE, AND THE KEYNESIAN VIEW

3. The multiplier principle is the concept that a change in one of the components of aggregate demand—investment, for example—will lead to a far greater change in the equilibrium level of income. Because the multiplier equals 1/(1–MPC), its size is determined by the marginal propensity to consume. The multiplier makes stabilizing the economy more difficult, because relatively small changes in aggregate demand have a much greater effect on equilibrium income.

6. Either an increase in government expenditures or a reduction in taxes should be employed to shift the budget toward a larger deficit (or smaller surplus).

8. Automatic stabilizers are built-in features (unemployment compensation, corporate profit tax, progressive income tax) that tend automatically to promote a budget deficit during a recession and a budget surplus (or smaller deficit) during an inflationary boom. Automatic stabilizers have the major advantage of providing needed restraint, or stimuli, without congressional approval—which, in turn, minimizes the problem of proper timing.

10. This statement depicts the views of many economists three decades ago. Today, most economists recognize that it is naive. Given our limited ability to forecast future economic conditions accurately, timing fiscal policy is more difficult than was previously thought. Political considerations—remember, the government is merely an alternative form of social organization, not a corrective device—reduce the likelihood that fiscal policy will be used as a stabilization tool. Changes in interest rates and private spending may offset fiscal actions and thereby reduce the potency of fiscal policy. All factors considered, it is clear that the use of fiscal policy to stabilize the economy is both difficult and complex.

CHAPTER 12: FISCAL POLICY, INCENTIVES, AND SECONDARY EFFECTS

2. The crowding-out effect is the theory that budget deficits will lead to higher real interest rates, which retard private spending. The crowding-out effect indicates that fiscal policy will not be nearly as potent as the simple Keynesian model implies. The new classical theory indicates that anticipation of higher future taxes (rather than higher interest rates) will reduce private spending when government expenditures are financed by debt.

10. In the Keynesian model, investment is determined by factors other than the interest rate. Thus, budget deficits would not exert much effect on capital formation. In the crowding-out model, capital formation would be reduced because the budget deficits would lead to higher interest rates, which would crowd out private investment. In the new classical model, households will save more, and, as a result, budget deficits could be financed without either an increase in the interest rate or a reduction in capital formation.

13. Yes. Only the lower rates would increase the incentive to earn marginal income and thereby stimulate aggregate supply.

15. No. If it takes more workers to generate a specific amount of energy with wind power, this implies that wind power is a more costly method of generating energy than either coal or natural gas. Thus, the implications of the statement are exactly the opposite of what the wind energy proponents imply.
CHAPTER 13: MONEY AND THE BANKING SYSTEM

1. A liquid asset is one that can easily and quickly be transformed into money without experiencing a loss of its market value. Assets such as high-grade bonds and stocks are highly liquid. In contrast, illiquid assets cannot be easily and quickly converted to cash without some loss of their value. Real estate, a family-owned business, business equipment, and artistic works are examples of illiquid assets.

3. Money is valuable because of its scarcity relative to the availability of goods and services. The use of money facilitates (reduces the cost of) exchange transactions. Money also serves as a store of value and a unit of account. Doubling the supply of money while holding output constant would simply cause its purchasing power to fall without enhancing the services that it performs. In fact, fluctuations in the money supply generally create uncertainty about the future value of money and thereby reduce its ability to serve as a reliable store of value, accurate unit of account, and medium of exchange for time-dimension contracting.

6. a. There is no change; currency held by the public increases, but checking deposits decrease by an equal amount.  
   b. Bank reserves decrease by $100.  
   c. Excess reserves decrease by $100, minus $100 multiplied by the required reserve ratio.

8. Answers (b), (e), and (f) will reduce the money supply; (a) and (c) will increase it. If the Treasury’s deposits (or the deposits of people who receive portions of the Treasury’s spending) are considered part of the money supply, then (d) will leave the money supply unchanged.

10. Whereas the transformation of deposits into currency does not directly affect the money supply, it does reduce the excess reserves of banks. The reduction in excess reserves will cause banks to reduce their outstanding loans and thereby shrink the money supply. Therefore, an increase in the holding of currency relative to deposits will tend to reduce the supply of money.

12. There are two major reasons. First, the money supply can be altered quietly via open market operations, whereas a reserve requirement change focuses attention on Fed policy. Second, open market operations are a fine-tuning method, whereas a reserve requirement change is a blunt instrument. Generally, the Fed prefers quiet, marginal changes to headline-grabbing, blunt changes that are more likely to disrupt markets.

13. a. False; statements of this type often use “money” when they are really speaking about wealth (or income).  
   b. False; the checking deposit also counts as money. In addition, the deposit increases the reserves of the receiving bank and thereby places it in a position to extend additional loans that would increase the money supply.  
   c. False; only an increase in the availability of goods and services valued by people will improve Americans’ standard of living. Without an additional supply of goods and services, more money will simply lead to a higher price level.

16. a. Money supply increases by $100,000;  
   b. $80,000;  
   c. $500,000;  
   d. no; there will be some leakage in the form of additional currency holdings by the public and additional excess reserve holdings by banks.

18. a. Money supply will increase by $2 billion;  
   b. $1.8 billion;  
   c. $20 billion.

CHAPTER 14: MODERN MACROECONOMICS AND MONETARY POLICY

2. Choices (a) and (c) would increase your incentive to hold money deposits; (b) and (d) would reduce your incentive to hold money.

3. a. The cost of obtaining the house is $100,000.  
   b. The cost of holding it is the interest forgone on the $100,000 sales value of the house.  
   c. The cost of obtaining $1,000 is the amount of goods one must give up in order to acquire the $1,000. For example, if a pound of sugar sells for 50 cents, the cost of obtaining $1,000 in terms of sugar is 2,000 pounds.  
   d. As in the case of the house, the cost of holding $1,000 is the interest forgone.
7.  a. Bank reserves will decline; b. Real interest rates will rise; c. Spending on consumer durables will fall; d. The dollar will appreciate because the higher interest rates will attract bond purchases by foreigners; e. Exports will decline because the appreciation of the dollar will make U.S. goods more expensive for foreigners; f. The higher real interest rates will tend to reduce real asset prices; g. Real GDP will fall.

10. If the time lag is long and variable (rather than short and highly predictable), it is less likely that policy makers will be able to time changes in monetary policy so that they will exert a countercyclical effect on the economy. The policy makers will be more likely to make mistakes and thereby exert a destabilizing influence.

11. Association does not reveal causation. Decision makers, including borrowers and lenders, will eventually anticipate a high rate of inflation and adjust their choices accordingly. As the expected rate of inflation increases, the demand for loanable funds will increase and the supply will decrease. This will lead to higher nominal interest rates. Thus, economic theory indicates that the causation tends to run the opposite direction from that indicated by the statement.

CHAPTER 15: STABILIZATION POLICY, OUTPUT, AND EMPLOYMENT

2. Compared with earlier periods, the United States has experienced less economic instability since 1960. This has been particularly true during the past twenty-five years. An increase in the stability of monetary policy deserves much of the credit for the more stable economic conditions of recent decades.

5. For (a) and (b), the actual and natural rates of unemployment will be equal. For (c), the actual rate will be less than the natural rate. For (d), the actual rate will exceed the natural rate.

7. Here are three practical problems that limit the effectiveness of discretionary macro policy as a stabilization tool: (1) inability to forecast the future direction of the economy with a high degree of accuracy, (2) lengthy and uncertain time lags between when a policy change is instituted and when the primary effects are felt, and (3) political factors that make it difficult to alter fiscal policy quickly.

11.  a. Keep the inflation rate at a low and highly predictable level; b. No; c. Both nominal interest rates and the general level of prices will rise.

CHAPTER 16: CREATING AN ENVIRONMENT FOR GROWTH AND PROSPERITY

3. If poor countries follow sound policies and provide an attractive economic environment, foreigners will be willing to supply investment funds. Propelled by foreign investment, some poor countries have achieved exceedingly high rates of both investment and growth during recent decades.

5. Competition is important because it encourages producers to supply goods that consumers value highly relative to cost, and to do so efficiently. Firms that fail to do so will be unable to compete effectively, and eventually they will be driven out of business. In turn, this will release the resources for use in the production of other things that are more highly valued.

8. When considering the answer to this question, think about the following: Is there an opportunity cost of the capital used by government firms? Do government firms have a strong incentive to keep costs low? Are government firms innovative?

12. The increase in diversity provides consumers with more options and thereby improves their welfare. For the most part, the GDP figures fail to capture the impact of this factor.

13. Regulations such as price ceilings, price floors, and mandated product characteristics will generally reduce the volume of gains from trade. Simultaneously, they will encourage rent-seeking activities, which will increase the contributions available to political officials.
CHAPTER 17: INSTITUTIONS, POLICIES, AND CROSS-COUNTRY DIFFERENCES IN INCOME AND GROWTH

8. It is hard to see how the less-developed economies could have grown so rapidly without borrowing technologies and ideas from the high-income countries. The high-income countries also provided both investment capital and markets for the sale of products for the LDCs. Historical growth records buttress this view. The per capita incomes of several economies, including Hong Kong, Singapore, South Korea, and China, have grown at annual rates of 5 percent or more over periods of twenty-five years or more. Prior to 1960, no country was able to achieve long-term growth at anywhere near such a rate. By way of comparison, per capita income in the United Kingdom and the United States grew at an annual rate of approximately 1 percent during the nineteenth century when countries with significantly higher incomes were absent.

9. In order to make a high score on the EFW index, a country must rely extensively on markets, protect property rights and enforce the law in an even-handed manner, provide for monetary/price stability, refrain from policies that restrict trade, and keep taxes low.

11. A country does not have to be democratic in order to be economically free. Hong Kong illustrates this point. Neither does democracy guarantee economic freedom. India was democratic, but it was one of the world’s least free economies prior to 1990.

13. Quality of the legal system: Does it protect property rights and enforce contracts fairly; tax rates; freedom to trade with others; onerous regulations, to list a few of the factors.

14. Poor economic institutions and policies provide the primary reason.

15. Because citizens can move elsewhere at a low cost. When significant numbers vote with their feet by leaving an area, the tax base will erode and this confronts politicians with an incentive to change their ways.

CHAPTER 18: GAINING FROM INTERNATIONAL TRADE

2. Availability of goods and services, not jobs, is the source of economic prosperity. When a good can be purchased cheaper abroad than it can be produced at home, a nation can expand the quantity of goods and services available for consumption by specializing in the production of those goods for which it is a low-cost producer and trading them for the cheap (relative to domestic costs) foreign goods. Trade restrictions limiting the ability of Americans to purchase low-cost goods from foreigners stifle this process and thereby reduce the living standard of Americans.

4. Statements (a) and (b) are not in conflict. Because trade restrictions are typically a special-interest issue, political entrepreneurs can often gain by supporting them even when they promote economic inefficiency.

6. True. The primary effect of trade restrictions is an increase in domestic scarcity. This has distributional consequences, but it is clear that, as a whole, a nation will be harmed by the increased domestic scarcity that accompanies the trade restraints.

8. a. No. Americans would be poorer if we used more of our resources to produce things for which we are a high-opportunity-cost producer and less of our resources to produce things for which we are a low-opportunity-cost producer. Employment might either increase or decrease, but the key point is that it is the value of goods produced, not employment, that generates income and provides for the wealth of a nation. The answer to (b) is the same as (a).

10. In thinking about this issue, consider the following points. Suppose that the Japanese were willing to give products such as automobiles, electronic goods, and clothing to us free of charge. Would we be worse off if we accepted the gifts? Should we try to keep the free goods out? What is the source of real income—jobs or goods and services? If the gifts make us better off, doesn’t it follow that partial gifts would also make us better off?

12. Although trade reduces employment in import-competing industries, it expands employment in export industries. On balance, there is no reason to believe that trade either promotes or destroys jobs. The major effect of trade is to permit individuals, states, regions, and nations to generate a larger output by specializing in the things they do well and trading for those things that they would produce only at a high cost. A higher real income
is the result.

14. The quota reduces the supply of sugar to the domestic market and drives up the domestic price of sugar. Domestic producers benefit from the higher prices at the expense of domestic consumers (see Exhibit 9). Studies indicate that the quota expanded the gross income of the 11,000 domestic sugar farmers by approximately $130,000 per farm in the mid-1980s, at the expense (in the form of higher prices of sugar and sugar products) of approximately $6 per year to the average domestic consumer. Because the program channels resources away from products for which the United States has a comparative advantage, it reduces the productive capacity of the United States. Both the special-interest nature of the issue and rent-seeking theory explain the political attractiveness of the program.

16. True. If country A imposes a tariff, other countries will sell less to A and therefore acquire less purchasing power in terms of A’s currency. Thus, they will have to reduce their purchases of A’s export goods.

CHAPTER 19: INTERNATIONAL FINANCE AND THE FOREIGN EXCHANGE MARKET

1. The Japanese cameras will become more expensive, and the quantity purchased by Americans will decline.

4. On February 2, the dollar appreciated against the British pound and depreciated against the Canadian dollar.

5. Scenarios (a) and (g) would cause the dollar to appreciate; (b), (c), (d), (e), and (h) would cause the dollar to depreciate; (f) would leave the exchange rate unchanged.

8. Some people fear that foreign investment makes the United States vulnerable because foreigners might decide to sell their assets and leave suddenly. When you consider this argument, it is important to recognize that foreign and domestic investors are influenced by pretty much the same considerations. Anything that would cause foreigners to withdraw funds would also cause domestic investors to do likewise. In fact, the vulnerability runs the other way. If foreign investors were to leave, the assets financed by their funds would remain. Thus, they would be in a weak position to impose harm on the U.S. economy.

9. Each of the changes would reduce the size of the current-account deficit.

11. The current-account balance will move toward a larger deficit (or smaller surplus), and the dollar will appreciate.

13. False. Flexible exchange rates bring the sum of the current and capital accounts into balance, but they do not necessarily lead to balance for either component.

14. a. No. The exchange rate will bring the overall purchases and sales into balance, but there is no reason to expect the imports and exports to any given country to be in balance.

b. The United States imports large quantities of goods Japan and China produce at a low cost (for example, electronic products, and labor intensive goods like toys and textiles), but it is not a major exporter of goods purchased intensively by these countries (natural resources, building materials, and inexpensive consumer items).

15. These purchases increase the foreign exchange value of the dollar, which makes imports cheaper relative to exports and thereby enlarges the trade deficit. Politicians often charge that this reduces output and employment. However, the bond purchases are an inflow of capital that will also result in lower U.S. interest rates, which will tend to stimulate output and employment. Thus, there is little reason to believe that the net effect will be either substantial or harmful.
SPECIAL TOPICS

SPECIAL TOPIC 1: GOVERNMENT SPENDING AND TAXATION

1. Taxes reduce economic efficiency because they eliminate some exchanges and thereby reduce the gains from these transactions. Because of (a) the deadweight losses accompanying the elimination of exchanges and (b) the cost of collecting taxes, the costs of additional tax revenue will be greater than the revenue transferred to the government. Studies indicate that it costs between $1.20 and $1.30 for each dollar of tax revenue raised by the government.

5. As we discussed in Chapter 6, the political process works better when there is a close relationship between who pays for and who benefits from government programs. An increase in the number of people who pay no income taxes is likely to weaken this relationship. Whereas those with low incomes pay payroll taxes, the revenues from this tax are earmarked for the finance of the Social Security and Medicare programs. Thus, expansions in government are financed primarily by the personal income tax. In the future, exemption of large numbers of people from this tax is likely to make it more difficult to control the growth of government. If you do not have to help pay for more government spending, why would you oppose it?

SPECIAL TOPIC 2: THE INTERNET: HOW IS IT CHANGING THE ECONOMY?

2. Airline tickets can be “transported” electronically; groceries cannot. Customers can observe the ticket information online, but they cannot observe the condition of fruits, vegetables, and other grocery products via the Internet.

SPECIAL TOPIC 3: THE ECONOMICS OF SOCIAL SECURITY

2. The pay-as-you-go Social Security system will face a crisis sometime around 2018, when the inflow of tax revenue will be insufficient to cover the promised benefits. Although the Social Security Trust Fund has bonds, they are merely an IOU from the Treasury to the Social Security Administration. To redeem these bonds and provide additional funds to finance Social Security benefits, the federal government will have to raise taxes (or pay the interest on additional Treasury bonds it sells), or cut other expenditures, or both. Thus, the presence of the SSTF bonds does not do much to alleviate the crisis.

SPECIAL TOPIC 4: THE STOCK MARKET: ITS FUNCTION, PERFORMANCE, AND POTENTIAL AS AN INVESTMENT OPPORTUNITY

1. History shows that in the U.S. stock market, fairly high returns can be gained at a relatively low risk by people who hold a diverse portfolio of stocks in unrelated industries for a period of twenty years or more. An indexed equity mutual fund is an option that would allow a person to purchase a diverse portfolio while keeping commission costs low.

3. The expectation of high profits in the future drove up the price of the stock, despite the lack of a dividend payment in the first years of the firm. Investors are equally happy with high dividends or the equivalent in rising stock value due to the firm’s retaining its profits for further investment.

5. Investors are buying such a stock for its rising value (price), which reflects expected future earnings and dividends.
SPECIAL TOPIC 5: THE CRISIS OF 2008: CAUSES AND LESSONS FOR THE FUTURE

3. The less equity the owner has in his or her house, the more likely he or she will default. This is particularly true in the United States because most home mortgages here are nonrecourse loans: the owner is not responsible for the debt beyond turning the property over to the lender in case of default. The lender has no legal claim on assets of the borrower beyond the asset that was mortgaged. Thus, when the value of a house falls below the outstanding loan, the borrower will often gain by simply abandoning the property. This is precisely what many have done in recent years.

5. The incentive to evaluate the borrower’s creditworthiness carefully is reduced. If the mortgage originator had to keep the loan until it was repaid, there would be greater incentive for the lender to evaluate the creditworthiness of the borrower more diligently.

SPECIAL TOPIC 6: LESSONS FROM THE GREAT DEPRESSION

5. The statement reflects a failure to recognize the secondary effects of limiting imports. If we buy less from foreigners, they will have fewer dollars that are required for the purchase of our exports. Therefore, a reduction in imports will also reduce exports and there is no reason to expect any net increase in employment. Instead, trade restraints lead to less output and lower incomes.

SPECIAL TOPIC 7: LESSONS FROM THE JAPANESE EXPERIENCE

2. The growth of government spending as a share of GDP and the large and increasing budget deficits in the 1990s indicate that Japan’s fiscal policy was expansionary. It failed to stimulate aggregate demand and recovery.

4. The population in Japan of people aged sixty-five years and over increased from 12.0 percent of the total in 1990 to 17.3 percent in 2000. This tended to slow economic growth. The United States will experience a similar trend during 2010–2020, and it too will tend to slow the growth of the U.S. economy.

SPECIAL TOPIC 8: THE FEDERAL BUDGET AND THE NATIONAL DEBT

1. No. Both private corporations and governments can, and often do, have continual debt outstanding. Borrowers can continue to finance and refinance debt as long as lenders have confidence in their ability to pay. This will generally be the case as long as the interest liability is small relative to income (or the potential tax base).

3. No. Remember, trade is a positive-sum game. Bonds are sold to foreigners because they are offering a better deal (acceptance of a lower interest rate) than is available elsewhere. Prohibiting the sale of bonds to foreigners would result in higher real interest rates and less investment, both of which would adversely affect Americans.

5. Lower; voters do not enjoy paying taxes and, therefore, voter dissatisfaction places a restraint on higher taxes, which would also restrain expenditures if the budget had to be balanced. More efficiently, the restraint of tax increases would tighten the budget constraint and make the reality of opportunity cost more visible to both voters and politicians.

7. No. Yes.