

Name _____

PRENTICE HALL

ECONOMICS

Principles in Action

Guide to the Essentials of Economics



Boston, Massachusetts
Upper Saddle River, New Jersey

80 pages

What is Economics?

SECTION 1

SCARCITY AND THE FACTORS OF PRODUCTION

TEXT SUMMARY

People always have to make decisions about how to meet their needs and wants. A **need** is something people must have to survive, like air, food, and shelter. A **want** is something that people would like to have but is not necessary for survival. Economics is the study of how people make choices to satisfy their needs and wants.

People have to make such choices because of **scarcity**, the limited amounts of resources to meet unlimited desires.

Goods are objects, like cars and clothes. **Services** are actions that people do for others, such as teaching. A **shortage** occurs when a good or service is unavailable. Shortages occur when people have

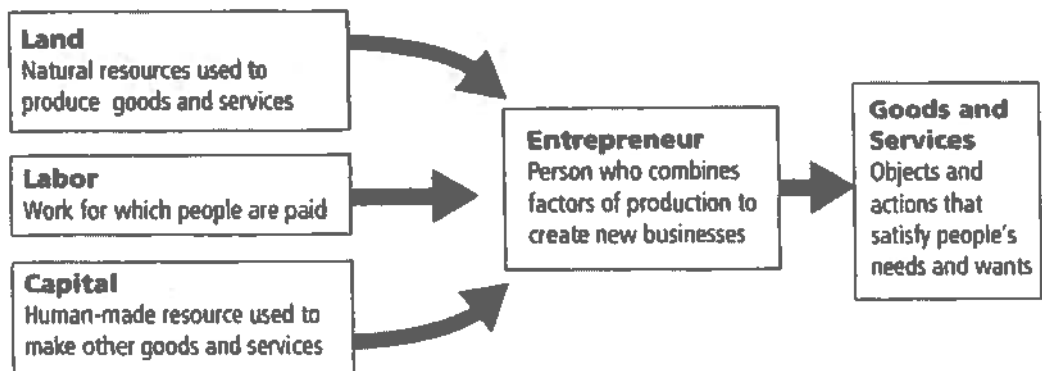
trouble supplying goods and services at current prices. Shortages may occur because of situations like war or drought. They may end quickly or last a long time.

Economists call the resources used to make goods and services **factors of production**. There are three types: land, labor, and capital. **Land** includes natural resources like coal, water, and forests. **Labor** is work for which people receive pay. **Capital** is a human-made resource used to produce other goods and services. Objects made by people, like buildings and tools, are called **physical capital**. **Human capital** refers to the knowledge and skills people gain from study and experience. **Entrepreneurs** are people who put together land, labor, and capital to create new businesses.

THE BIG IDEA

study of how people choose from limited resources to meet their needs and wants.

GRAPHIC SUMMARY: The Factors of Production



The three factors of production—land, labor, and capital—are used to create goods and services.

REVIEW QUESTIONS

1. What is scarcity?

2. **Diagram Skills** What is the name of any human-made resource that is used to make other goods and services?

TEXT SUMMARY

When making decisions people face **trade-offs**, or alternatives we give up when we choose one course of action over another. Individuals, businesses, and governments all face trade-offs. A person who chooses to spend more time at work has less time to spend at home. A business that uses all its factories to build chairs cannot build tables at the same time. A country that decides to produce more military goods has fewer resources to use for consumer goods. Economists use the term **guns or butter** to describe this trade-off.

A person who chooses one alternative gives up other alternatives. The most desirable alternative given up is called the **opportunity cost**. For example,

suppose you have to choose between sleeping late or getting up early to study for a test. The opportunity cost of extra study time is less sleep. The opportunity cost of more sleep is less study time.

Decisions also involve **thinking at the margin**. This means deciding about adding or subtracting one unit of a resource, such as one hour of sleep. In the example above, the decision was between sleeping late or studying. But you could also choose to sleep an hour late, then wake up to study. To make a decision at the margin, you would compare the opportunity cost and benefit of each extra hour of studying.

THE BIG IDEA

When people make choices, they must give up something. The most desirable choice they give up is called the opportunity cost.

GRAPHIC SUMMARY: Decision-Making at the Margin

Alternatives	Benefit	Opportunity Cost
1st hour of extra study time	Grade of C on test	1 hour of sleep
2nd hour of extra study time	Grade of B on test	2 hours of sleep
3rd hour of extra study time	Grade of B+ on test	3 hours of sleep

This grid shows one way to analyze a decision by identifying the opportunity costs and benefits at the margin.

REVIEW QUESTIONS

1. What is opportunity cost?
2. **Chart Skills** What is the opportunity cost of the first extra hour of study?

SECTION 3

PRODUCTION POSSIBILITIES CURVES

TEXT SUMMARY

Economists use graphs that are called **production possibilities curves** to show alternative ways of using a country's resources. For example, an economist might want to examine the production of shoes and watermelons. A production possibilities curve can show how the number of shoes produced is affected by the number of watermelons grown. As the number of watermelons produced is increased the number of shoes produced will decrease. This

happens because land is scarce, and more land for watermelon farms means less land for shoe factories. Similarly, as more shoes are produced less resources are available to grow watermelons.

Efficiency means an economy is using resources in such a way as to

maximize the production of goods and services. In the above example, efficiency would mean that the most watermelons and shoes possible are being produced. The line on the curve that shows the maximum possible production is called the **production possibilities frontier**. If factory workers and farmers lost their jobs, fewer shoes and watermelons would be produced. In this case the economy would suffer from **underutilization**, or using fewer resources than it is capable of using. A country's resources are always changing.

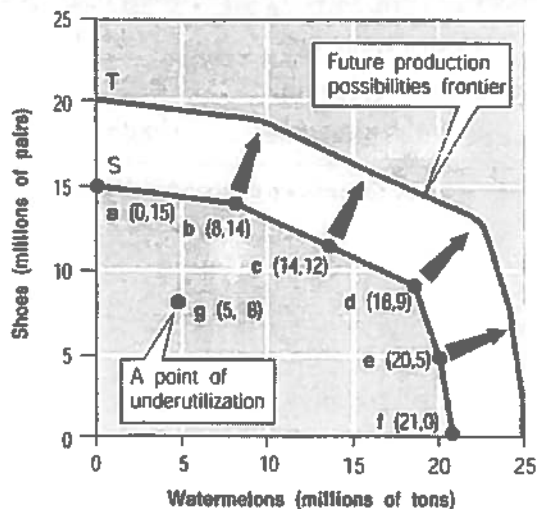
In the future, resources may increase, causing the economy to grow. If more labor becomes available, there will be more workers to produce more goods. Improvements in technology, or know-how, will also help the economy grow. This growth can be shown by a shift to the right on the production possibilities frontier.

THE BIG IDEA

Producers make decisions about how to use resources. Production possibilities graphs can be used to examine the opportunity costs of these decisions.

GRAPHIC SUMMARY: Production Possibilities Curve

This production possibilities curve shows a made-up country's trade-offs in producing shoes and watermelons. At point *a*, it produces no watermelons but all possible shoes. At point *f*, it produces no shoes and all possible watermelons.



REVIEW QUESTIONS

1. What is efficiency?

2. **Graph Skills** How many watermelons and shoes are produced at point *b* on the production possibility frontier?

CHAPTER 1 *Test***IDENTIFYING MAIN IDEAS**

Write the letter of the correct answer in the blank provided. (10 points each)

- _____ 1. Economics is the study of how people
- A. calculate their income tax.
 - B. choose from limited resources to meet their needs.
 - C. respond to war and drought.
 - D. gain knowledge and skills from study and experience.
- _____ 2. Shortages occur when
- A. many people are unemployed.
 - B. interest rates go up.
 - C. people have trouble supplying goods and services at current prices.
 - D. the United States imports more than it exports.
- _____ 3. The resources used to make goods and services are called
- A. factors of production.
 - B. gross national product.
 - C. production possibilities frontier.
 - D. opportunity cost.
- _____ 4. Entrepreneurs are people who
- A. help settle labor disputes.
 - B. work on the floor of the stock exchange.
 - C. put together land, labor, and capital to create new businesses.
 - D. produce all of a country's guns and butter.
- _____ 5. Giving up one alternative for another is called
- A. underutilization.
 - B. a trade-off.
 - C. human capital.
 - D. efficiency.
- _____ 6. Countries often have to choose between producing military or consumer goods, a trade-off economists call
- A. export or import.
 - B. a free market economy.
 - C. farm goods or factory goods.
 - D. guns or butter.
- _____ 7. Thinking at the margins means deciding about
- A. maximizing goods and services.
 - B. investing with borrowed money.
 - C. adding or subtracting one additional unit of some resource.
 - D. increasing or decreasing technological know-how.
- _____ 8. The purpose of a production possibilities curve is to
- A. show alternative ways to use an economy's resources.
 - B. show how a factory can use its workers in different ways.
 - C. give engineers a new way of deciding how to build manufacturing plants.
 - D. tell farmers how many watermelons to plant.
- _____ 9. Using resources in such a way as to maximize the production of goods and services is called
- A. efficiency.
 - B. underutilization.
 - C. thinking at the margins.
 - D. growth.
- _____ 10. A country's production possibilities will grow if it
- A. produces more guns than butter.
 - B. lowers its opportunity costs.
 - C. makes more trade-offs.
 - D. increases its resources.

CHAPTER
2

Economic Systems

SECTION 1

ANSWERING THE THREE ECONOMIC QUESTIONS

TEXT SUMMARY

Because economic resources are limited, a country must answer three key economic questions. These are: 1) What goods and services should be produced? 2) How should these goods and services be produced? 3) Who consumes these goods and services?

THE BIG IDEA

All countries must answer three key economic questions in deciding how to use their scarce economic resources.

In answering these questions, societies must consider their economic goals. Some goals, such as economic freedom or economic equity, are considered more important in some countries than in others. Other goals, like economic efficiency, are shared by most countries. Another important goal is growth and innovation. A nation's economy must grow in order to improve its **standard of living**, or level of prosperity.

Four types of **economic systems** have developed as societies attempt to answer the three economic questions according to their goals. An economic system is the method a society uses to produce and distribute goods and services. A **traditional economy** relies on custom to make most economic decisions. People grow up doing what their parents did, and there is little innovation or change. In a **market economy**, economic decisions are made by individuals and are based on exchange, or trade. Market economies are also known as the free market. In a **centrally planned economy**, the government makes most economic decisions. Most economies today are **mixed economies**, a combination of the three other economic systems.

GRAPHIC SUMMARY: Economic Goals

ECONOMIC EFFICIENCY	ECONOMIC FREEDOM	ECONOMIC SECURITY AND PREDICTABILITY	ECONOMIC EQUITY	ECONOMIC GROWTH AND INNOVATION
Maximizing output of goods and services from the resources available	Allowing individuals to make economic choices about earning income, owning property, and purchasing goods and services	Assuring people that goods and services will be available; providing aid for retirement and in difficult times	Dividing resources in a way that is considered fair	Encouraging the development of new ideas and skills; helping the economy grow

While most societies pursue all of these goals, a society may value some goals more than others.

REVIEW QUESTIONS

- How are decisions made in a market economy?
- Chart Skills** What is economic efficiency?

TEXT SUMMARY

None of us can produce everything we need and want. **Markets** exist so that people can exchange the things they have for the things they want. A market is an arrangement that allows buyers and sellers to exchange goods and services.

Markets function because of self-interest and competition. **Self-interest** means buyers and sellers are focused on personal gain. It motivates consumers to buy the goods and services they want at the lowest prices possible. **Competition** is the struggle among producers for the dollars of consumers. It keeps prices low as firms attempt to make their prices attractive to consumers. Together, self-interest and competition work to regulate the marketplace.

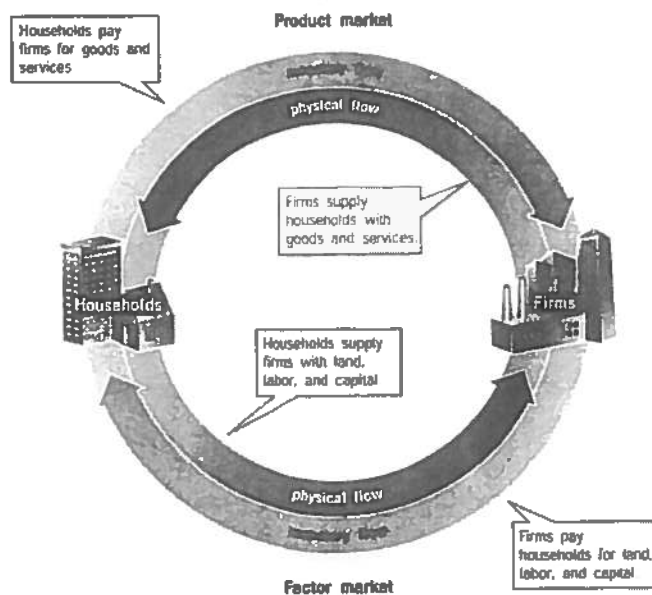
The factor market and the product market are the two main parts of the free market. In the **factor market**, firms purchase land, labor, and capital—the factors of production—from households. Firms rent land, hire workers, and borrow money from investors. In the **product market**, households purchase goods and services produced by firms.

The free market helps an economy meet many economic goals. It encourages efficiency, economic freedom, and innovation and growth. However, two other economic goals—security and equity—are difficult to achieve in a pure market system. Many societies have modified the free market to better meet their goals.

THE BIG IDEA

The free market system, based on self-interest and competition, has many advantages for societies that are attempting to meet their economic goals.

GRAPHIC SUMMARY: Factor Market and Product Market



This circular flow diagram shows interactions between businesses and households in the free market. In the top half, households purchase products made by businesses. In the bottom half, businesses purchase land, labor, and capital from households.

REVIEW QUESTIONS

1. What is competition, and what function does it serve in the free market?
2. **Diagram Skills** With what do firms supply households?

SECTION 3

CENTRALLY PLANNED ECONOMIES

TEXT SUMMARY

In a centrally planned economy, the central government, rather than individual producers and consumers in markets, answers the key economic questions about production and consumption. The government owns the land and the capital. It controls where people will work and how much they will be paid. It decides what is produced and at what price things will be sold.

In a communist society, individuals lack personal freedom.

The former Soviet Union was an example of a communist nation where most economic and political power was controlled by the central government. Under the Soviet system all workers were guaranteed employment and income. Factories and farms had to meet production goals set by the government.

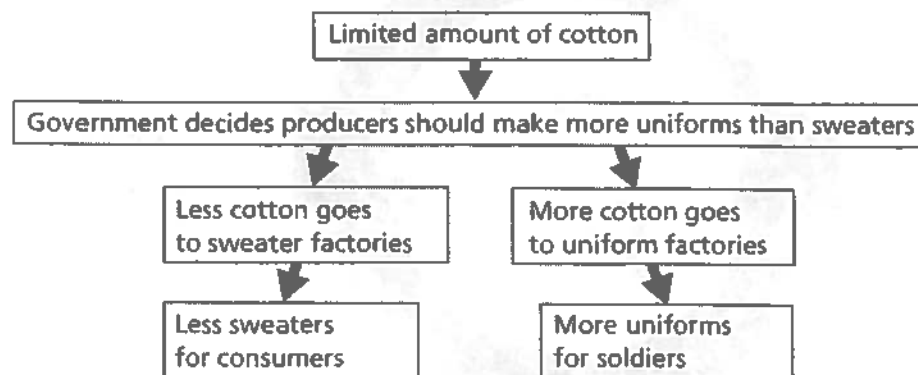
THE BIG IDEA

Centrally planned economies have disadvantages not found in market economies.

The terms **socialism** and **communism** are associated with centrally controlled economies. Socialists attach great value to the goal of economic equity. They believe that economic equality is possible only if the public controls the economy. Socialist countries may be democracies. Communists share many of the goals of socialists, but believe that these goals can only be achieved through violent revolution.

Centrally planned economies try to promote faster economic growth and more equal distribution of goods and services. However, these systems almost always fall short of their goals. Without the incentive of self-interest, producers have no reason to produce more or better products. Consumers find it difficult to meet their needs or wants, having to accept poorly-made merchandise. In addition, individual freedoms are limited.

GRAPHIC SUMMARY: Decision Making in a Centrally Planned Economy



In centrally planned economies the government makes all important economic decisions.

REVIEW QUESTIONS

1. In a centrally planned economy who decides how much goods will cost?
2. **Diagram Skills** How does the government's decision affect consumers and soldiers?

TEXT SUMMARY

No economic system has all the answers. The traditional economy offers little hope for growth or change. The centrally planned economy is slow-moving and offers consumers few choices or freedom. Market economies have many advantages but also have their limitations. For example, markets do not provide answers for some of society's needs, such as the need for defense, education, and fast transportation routes. Governments provide answers to these needs by maintaining armed forces, schools, and roads and bridges. Governments also enforce property rights and rules against unfair competition.

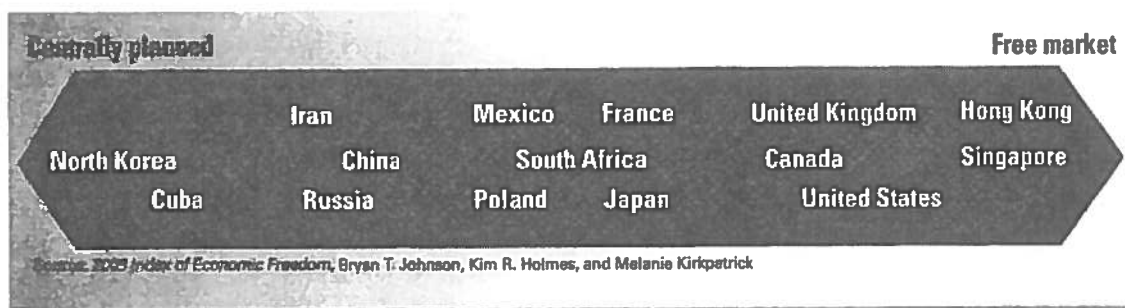
No country has an economy that is purely free market or purely controlled by the government. All are mixed economies, combining free markets with

government intervention, or involvement. There is a **continuum**—a range with no clear divisions—of economic systems. At one extreme, the North Korean economy is almost completely controlled by the government. China has a centrally planned economy but is in **transition**, a period of change, moving toward a market system. Hong Kong is governed by China, but has a separate economic system based on its years as a colony of Great Britain. This system is dominated by free markets.

Compared to most other nations, the United States has an economy with little government involvement and a great deal of economic freedom. Such a system is called **free enterprise**.

THE BIG IDEA

Most nations have mixed economies, which combine features of both centrally planned and free market economies.

GRAPHIC SUMMARY: A Continuum of Economic Systems

The world's nations vary greatly in economic systems. The left side of the diagram shows economies dominated by government. The right side shows economies dominated by the free market.

REVIEW QUESTIONS

1. What are examples of needs that are not easily met by free markets?

2. **Diagram Skills:** Which economies are at opposite ends of the range of economic systems?

CHAPTER 2 *Test*

IDENTIFYING MAIN IDEAS

Write the letter of the correct answer in the blank provided. (10 points each)

- _____ 1. Which of these is a key economic question faced by countries?
- A. How big should the army be?
 - B. How much money should be raised in taxes?
 - C. How many schools should be built?
 - D. What goods and services should be produced?
- _____ 2. In a traditional economy, economic decisions are based largely on
- A. custom.
 - B. science.
 - C. socialism.
 - D. technology.
- _____ 3. Markets allow us to
- A. get the highest prices for what we sell.
 - B. get the lowest prices for what we buy.
 - C. sell the most goods we possibly can.
 - D. exchange the things we have for the things we need.
- _____ 4. Competition and self interest are two important forces in
- A. free market economies.
 - B. traditional economies.
 - C. centrally planned economies.
 - D. communist economies.
- _____ 5. Which economic goals are best promoted by the free market?
- A. efficiency and freedom
 - B. efficiency and equity
 - C. innovation and security
 - D. Freedom and security
- _____ 6. Which is true of the government in a centrally planned economy?
- A. It builds every house in every village.
 - B. It encourages workers to innovate.
 - C. It makes all important economic decisions.
 - D. It places much emphasis on the production of consumer goods.
- _____ 7. Socialists believe that economic equality is only possible if
- A. everyone makes the same amount of money.
 - B. the public controls the economy.
 - C. medical care is free.
 - D. no one has to pay taxes.
- _____ 8. The former Soviet Union was an example of a communist country where
- A. individual freedom was allowed.
 - B. free enterprise was encouraged.
 - C. consumers had many choices.
 - D. most economic and political power was controlled by the government.
- _____ 9. Which of the following countries has the most extreme example of a centrally planned economy?
- A. North Korea
 - B. Hong Kong
 - C. China
 - D. Great Britain
- _____ 10. The free enterprise system of the United States is best described as a
- A. free market economy.
 - B. traditional economy.
 - C. mixed economy with limited government intervention and a great deal of economic freedom.
 - D. mixed economy with equal amounts of economic freedom and government intervention.

American Free Enterprise

SECTION 1

BENEFITS OF FREE ENTERPRISE

TEXT SUMMARY

There is a tradition of free enterprise in the United States—a tradition that encourages people to try out their business ideas and compete in the public market. Both Mr. Scappoose, the immigrant who opened a barber shop, and Bill Gates, the young man who founded Microsoft, are part of this tradition, and both are entrepreneurs with a desire to succeed and profit.

In the free enterprise economy, consumers, acting on their own, decide to buy products. Their individual choices signal the producers what to produce and how much to make. The result is a variety of products at reasonable prices.

We expect government to protect consumers by assuring that they have the information they need to make informed decisions.

Government laws, such as those protecting the right to private property and enforcing contracts, help Americans benefit from free enterprise. The Constitution also specifies how government can tax, and it prohibits government from interfering in business contracts. Finally, federal and state agencies regulate industries whose goods and services affect the well-being of the public.

THE BIG IDEA

Competition provides a variety of goods at reasonable prices.

GRAPHIC SUMMARY: Features of American Free Enterprise



These basic features of free enterprise are so familiar to us that we tend to take them for granted.

REVIEW QUESTIONS

1. What is the role of government in a free enterprise system?

2. **Diagram Skills** Which feature of American Free Enterprise describes the action taken by the consumer who buys a book from a bookstore?

PROMOTING GROWTH AND STABILITY

TEXT SUMMARY

To keep the huge American economy on course, government economists follow macroeconomic trends. **Macroeconomics** is the study of the behavior and decision making of entire economies. By contrast, **microeconomics** is the study of economic behavior of individuals, families, and businesses. Macroeconomic progress is measured by calculating a nation's **gross domestic product (GDP)**. This is the total value of all final goods and services produced in a year. Measuring the change in GDP from one year to the next is one way of measuring growth or decline in an economy.

economy and prevent wide swings, the government has three main goals: high employment, steady economic growth, and stable prices. Government policymakers use different policies and tools in their attempts to achieve these goals.

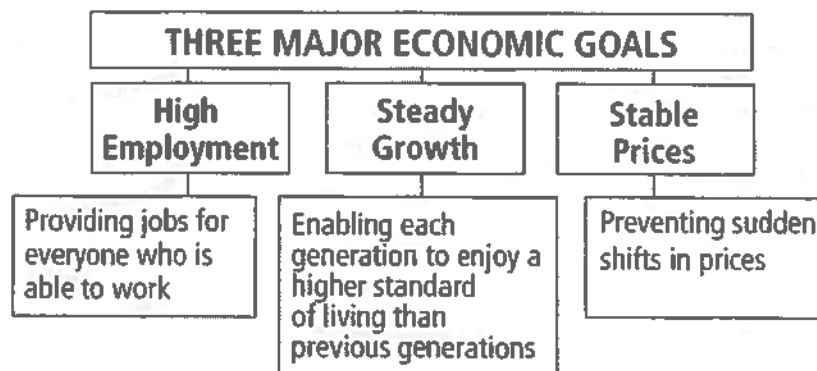
One way Americans maintain their high standard of living is by constantly improving technology. **Technology** is the process used to produce a good or service. Progress in technology helps the economy to be more efficient and productive. For example, Thomas Edison's invention of the light bulb in 1879 made possible a longer work day. To advance technological progress, government policies encourage innovation. Federal agencies fund research and development projects at universities and private companies. The government also provides patents and copyrights. This encourages inventors by protecting their ideas.

THE BIG IDEA

Government attempts to regulate business cycles and to encourage economic growth.

Free enterprise systems are subject to sudden swings in **business cycles**, periods of macroeconomic growth followed by slowing or decline. To stabilize the

GRAPHIC SUMMARY: Government Macroeconomic Goals



Government economists use a variety of policies in their attempt to achieve their three major goals.

REVIEW QUESTIONS

1. What is GDP, and how does studying it help economists?
2. **Diagram Skills** What are three major economic goals of government?

TEXT SUMMARY

People depend on the government to provide public goods. A **public good** is a shared good or service for which it would be inefficient or impractical to make consumers pay individually. Examples of public goods are roads, dams, and national defense. If the government did not provide these things, individuals or companies would have to themselves. But for an individual person or company, the cost of building a highway outweighs the benefits. Another characteristic of a public good is that it is difficult to exclude non-payers. Once a road is built, it is difficult to keep some drivers from using it. Situations such as road-building, in which the free market does not efficiently provide resources to solve a problem, are known as **market failures**.

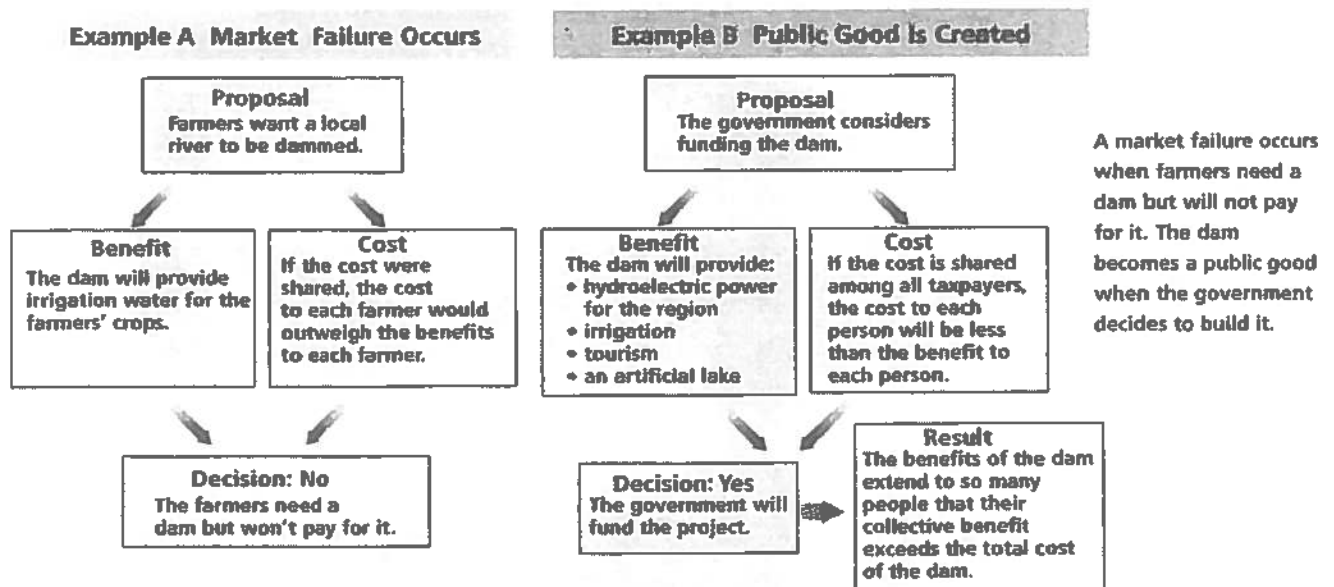
Public goods are paid for by the public sector. The **public sector** is the part of the economy which involves government transactions. The **private sector** involves transactions of individuals and businesses.

Externalities can affect the public and private sector. An **externality** is an economic side effect of a good or service. The government encourages the creation of positive externalities. Education, for example, benefits students, yet society as a whole benefits from an educated population. The government also works to limit negative externalities, such as automobile pollution.

THE BIG IDEA

The government attempts to provide goods and services when the market fails to do so efficiently.

GRAPHIC SUMMARY: Is a Dam a Public Good?



REVIEW QUESTIONS

1. Explain how the need for a new road might be an example of market failure.
2. **Diagram Skills** What is the result of the government's decision to build the dam?

SECTION 4

PROVIDING A SAFETY NET

TEXT SUMMARY

Free markets tend to spread wealth unevenly. This leaves some people below the poverty threshold. The **poverty threshold** is the minimum level of income, as determined by the government, that is needed to support a household. To help ease poverty, the government collects tax money and redistributes it to people who are poor or otherwise in need. This kind of aid is known as **welfare**.

In the 1990s, welfare programs became subject to much debate. Critics charged that people were becoming dependent on their welfare payments and were not doing enough to help themselves.

Despite these debates, welfare programs continue to function in

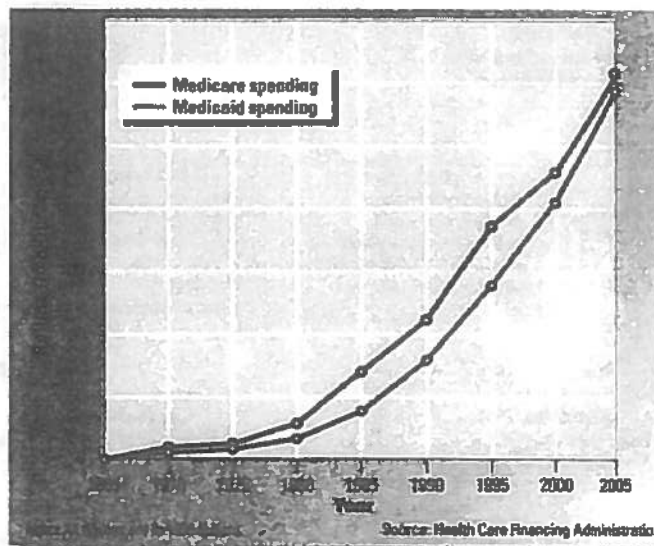
the United States. One major program is Temporary Aid to Needy Families (TANF). It uses **cash transfers**, direct payments of money, to help poor people. Money provided by the federal government goes to the states, which design their own welfare programs. Another major program is Social Security, which provides cash transfers to the elderly retired and to people who are disabled. It is funded from taxes on people's wages. The government also provides **in-kind benefits**—goods and services provided for free or at very low prices. Examples of in-kind benefits include food stamps and subsidized housing. Another important social service that the government provides is health insurance. Medicare, which provides aid to the elderly, and Medicaid, which assists the poor, are two health insurance programs.

THE BIG IDEA

Because the free market system tends to distribute wealth unevenly, the government runs programs to help people in need.

GRAPHIC SUMMARY: Spending on Two Government Programs

The costs of both Medicare and Medicaid have increased substantially since they were created.



REVIEW QUESTIONS

1. What are cash transfers?
2. **Graph Skills** Does government spend more on Medicare or on Medicaid?

CHAPTER 3 *Test*

IDENTIFYING MAIN IDEAS

Write the letter of the correct answer in the blank provided. (10 points each)

- | | |
|---|--|
| <p>_____ 1. The public interest is</p> <ul style="list-style-type: none"> A. the concerns of the public as a whole. B. the right to buy and sell goods. C. the right of individuals to have safe products. D. a property right guaranteed by law. <p>_____ 2. Public disclosure laws require</p> <ul style="list-style-type: none"> A. governments to disclose their standards. B. companies to protect private property. C. companies to give information about their products. D. individuals to use only written contracts. <p>_____ 3. The minimum income needed to support a household is</p> <ul style="list-style-type: none"> A. the standard of living. B. the poverty threshold. C. a cash transfer. D. in-kind benefits. <p>_____ 4. Temporary Aid to Needy Families (TANF) is an example of</p> <ul style="list-style-type: none"> A. an in-kind benefit. B. Social Security. C. a welfare program. D. government health insurance. <p>_____ 5. Which of the following is NOT an example of a public good?</p> <ul style="list-style-type: none"> A. a shopping mall B. an airport C. a dam D. a park | <p>_____ 6. A market failure is a situation where</p> <ul style="list-style-type: none"> A. the market does not distribute resources efficiently. B. a non-payer is not allowed in public places. C. entrepreneurs will not pay for public services. D. the private sector cannot pay market price for public goods. <p>_____ 7. Pollution caused by automobiles is an example of</p> <ul style="list-style-type: none"> A. an inefficient allocation of resources. B. a positive externality. C. a negative externality. D. the public sector. <p>_____ 8. One of the best ways of measuring a nation's economic progress is to calculate</p> <ul style="list-style-type: none"> A. the strength of its technology. B. the duration of its positive business cycles. C. its unemployment rate. D. its gross domestic product. <p>_____ 9. What are the three main goals of the government in its attempt to keep the economy running smoothly?</p> <ul style="list-style-type: none"> A. high interest rates, steady growth, and regulated prices B. high employment, steady growth, and stable prices C. well-regulated banks, slow growth, and low prices D. rapid business cycles, rapid growth, and fair prices <p>_____ 10. One way Americans maintain their high standard of living is by constantly improving</p> <ul style="list-style-type: none"> A. technology. B. microeconomic policy. C. patents and copyrights. D. macroeconomic trends. |
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CHAPTER
4

Demand

SECTION 1

UNDERSTANDING DEMAND

TEXT SUMMARY

The **law of demand** states that a good's price has an important effect on the amount of that good people will buy. The lower the price, the more consumers will buy. Similarly, the higher the price, the less consumers will buy. More people will buy a slice of pizza priced at \$1 than at \$10.

The law of demand results from two patterns of human behavior. The first, known as the **substitution effect**, says that as the price of a good rises, people are more likely to *substitute* alternative goods. When the price of pizza becomes more expensive compared to other foods, like tacos, people are more likely to buy those other foods. The result is that the demand for pizza drops.

However, if the price of pizza drops, consumers are more likely to substitute pizza for other choices. This causes the demand for pizza to rise.

The other pattern is known as the **income effect**. When the price of pizza and other goods rise, people are likely to feel poorer. The income effect takes place when a consumer responds to a price increase by spending more on that good, even though it is more expensive. They spend more, but usually buy less.

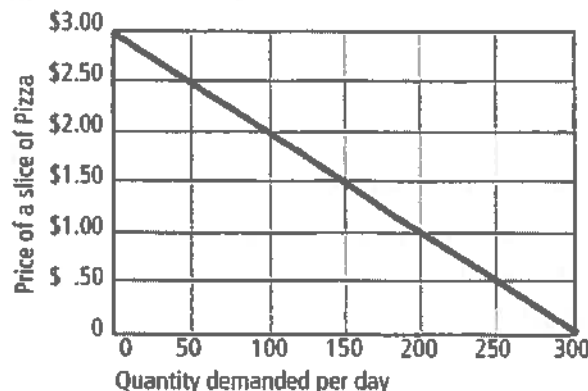
A **demand curve** illustrates the quantities demanded at each price by consumers in the market. The vertical axis shows price, and the horizontal axis shows the quantity demanded. Because demand rises as prices fall, the demand curve slopes down and to the right.

THE BIG IDEA

The law of demand says that people will buy less of a good when its price rises, and more of a good when its price falls.

GRAPHIC SUMMARY: Market Demand Curve

The demand curve shows the relationship between a good's price and the demand for that good. Since demand increases as prices fall, the curve slopes down to the right.



REVIEW QUESTIONS

1. According to the law of demand, a fall in the price of milk has what effect on the amount of milk people will buy?
2. **Graph Skills** At \$.50 per slice, what is the demand for pizza per day?

SECTION 2

SHIFTS OF THE DEMAND CURVE

TEXT SUMMARY

Many other factors besides price can affect the demand for goods. For example, if it was discovered that tomato sauce was extremely good for your health, demand for pizza would rise. Consumers would want to buy more pizza at all price levels. This increase in demand shifts the entire demand curve to the right. If it was announced that tomato sauce was unhealthy, then people would buy less pizza at all price levels. This decrease in demand shifts the demand curve to the left.

Other factors can shift the demand curve. For example, if your income were to rise, you might buy more pizza. Higher income causes people to buy more of most goods at every price level. This creates a shift to the right of the

demand curve. Similarly, a decrease in income causes demand for most goods to fall.

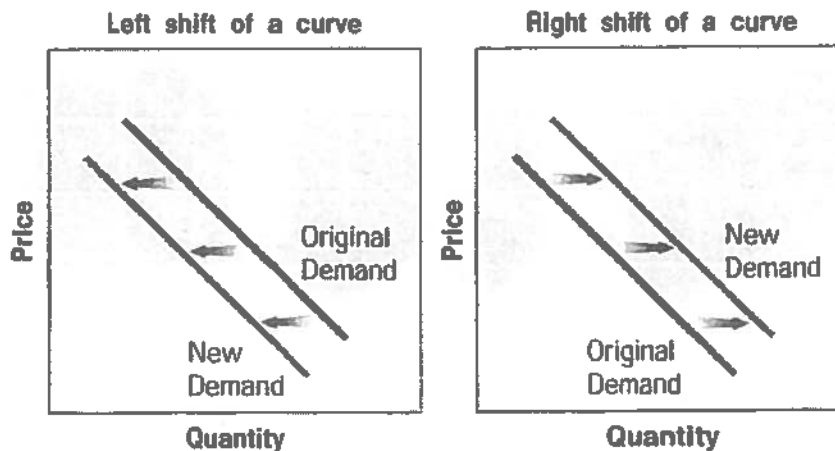
Changes in population will affect demand. For example, an increase in the number of senior citizens is likely to increase the demand for medical care. Advertising and fashion trends can also have a big effect on consumer demand.

The demand for one good can also affect the demand for other goods. **Complements** are two goods that are bought and used together. People who buy skis are likely to buy ski boots. **Substitutes** are goods used in place of one another. When people buy more snowboards they will buy fewer skis.

THE BIG IDEA

Many factors besides price can change the demand for goods.

GRAPHIC SUMMARY: Shifts of the Demand Curve



An increase in demand causes more of a good to be demanded at all price levels. This shifts the demand curve to the right. A decrease in demand causes less of a good to be demanded, shifting the demand curve to the left.

REVIEW QUESTIONS

1. How does an increase in income affect the demand for most goods?
2. **Graph Skills** What change in demand is illustrated by a shift to the left of the demand curve?

SECTION 3

ELASTICITY OF DEMAND

TEXT SUMMARY

Economists use the term **elasticity of demand** to describe the way people respond to price changes. If you keep buying despite a price increase, your demand is **inelastic**. If you buy less after a small price increase your demand is **elastic**. Demand tends to be inelastic for goods that have few substitutes, like medicines, or for goods that are considered essential, like milk.

percent decrease. The change in price is a 50 percent increase. The elasticity of demand is 25 percent divided by 50 percent, or .5. Since this number is less than 1, the demand is inelastic—customers continue to buy even if the price increases. A demand that is more than 1 is elastic.

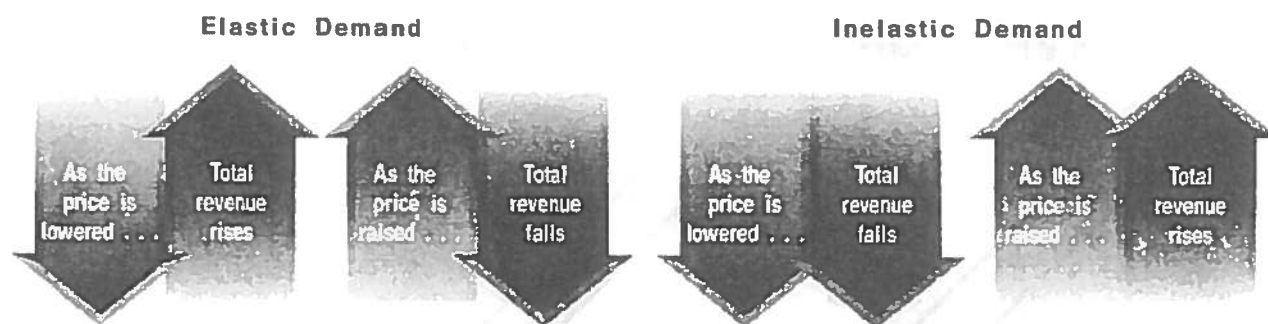
Elasticity is an important tool for business owners. It helps them to determine how a change in prices will affect their business's **total revenue**, or the amount of money the company receives by selling its goods. If a business faces elastic demand, then raising prices will result in a sharp drop in demand, decreasing total revenue. However, when a good has an inelastic demand, a business might be able to increase its total revenue by increasing the price.

THE BIG IDEA

Elasticity of demand describes how people react to changes in prices.

To compute elasticity of demand, take the percentage change in the demand of a good and divide this number by the percentage change in the price of the good. Say that if the price of pizza rises from \$1.00 to \$1.50, demand falls from 4 to 3 slices per day. The change in demand is a 25

GRAPHIC SUMMARY: Total Revenue and Elasticity



If a business sells a product with elastic demand, consumers are very responsive to price changes. A small price rise could result in much less demand, reducing total revenue. If demand is inelastic, a price rise will not affect demand quite so sharply. Consumers will buy nearly as much of the product at higher prices, and total revenue will rise.

REVIEW QUESTIONS

1. Explain why the demand for a particular brand of apple juice is elastic.
2. **Diagram Skills** What happens if demand is elastic and the price is lowered?

CHAPTER 4 *Test*

IDENTIFYING MAIN IDEAS

Write the letter of the correct answer in the blank provided. (10 points each)

- _____ 1. The law of demand says
- A. the higher the price, the more consumers will buy.
 - B. the lower the price, the less consumers will buy.
 - C. the lower the price, the more consumers will buy.
 - D. the lower the price, the more consumers will substitute.
- _____ 2. A drop in price will
- A. increase the demand for goods.
 - B. decrease the demand for goods.
 - C. not affect the demand for goods.
 - D. not affect the law of demand.
- _____ 3. Which of the following describes the substitution effect?
- A. As the price of a good falls, people will substitute other products.
 - B. As the price of a good rises, people will substitute other products.
 - C. As demand rises, people will substitute other products.
 - D. As demand falls, people will substitute other products.
- _____ 4. A demand curve illustrates
- A. the differences in price charged by different stores.
 - B. the quantities demanded at each price by consumers.
 - C. the differences in demand for different products.
 - D. the products which are most in demand.
- _____ 5. For most goods, a rise in people's income means that there will be
- A. a substitution effect.
 - B. a rise in prices.
 - C. an increase in demand.
 - D. a decrease in demand.
- _____ 6. Which of the following is NOT an example of complements?
- A. skis and ski boots
 - B. row boat and oars
 - C. electric shaver and charging cord
 - D. calculator and cell phone
- _____ 7. Substitutes are
- A. goods that are bought and used together.
 - B. goods used in place of one another.
 - C. goods that cannot be replaced.
 - D. goods which cause a shift in the demand curve.
- _____ 8. If you keep buying despite a price increase, your demand is
- A. elastic.
 - B. strong.
 - C. normal.
 - D. inelastic.
- _____ 9. Which of the following is an example of a good with inelastic demand?
- A. life-saving medicine
 - B. television sets
 - C. computers
 - D. a particular brand of chewing gum
- _____ 10. Total revenue is defined as
- A. the amount of profit a company makes.
 - B. the amount of profit a company makes after paying taxes.
 - C. the amount of money a company makes by selling its goods.
 - D. the amount of money affected by price elasticity.

CHAPTER
5

Supply

SECTION 1

UNDERSTANDING SUPPLY

TEXT SUMMARY

As the price of a good rises, firms will produce more to make more revenue. New firms will have an incentive to enter the market. The tendency of suppliers to offer more of a good at a higher price is called the **law of supply**. This law states that the higher the price, the larger the quantity produced. If the price of a good falls, less of a good will be produced. Some firms will produce less, and others might drop out of the market.

A **market supply curve** illustrates the quantity supplied by all producers in a market at different prices. For example, a market supply curve could show the quantity of pizza

supplied by all the pizzerias in a city. A supply curve always rises from left to right. That is because higher prices lead to higher output.

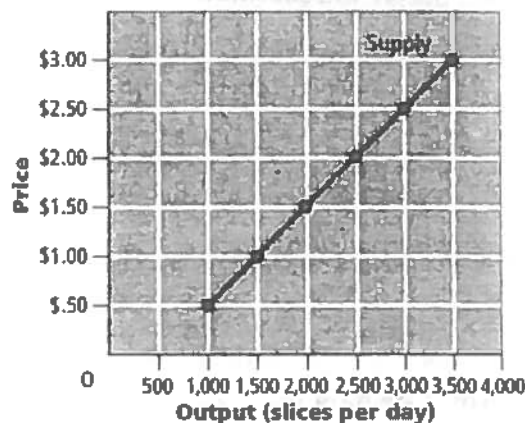
Elasticity of supply is a concept that predicts how suppliers react to price changes. Industries that cannot easily alter production have inelastic supply. Orange growers, for example, cannot increase production quickly when prices rise. They need to purchase more land and plant more trees in order to increase output. A service industry like a barbershop has elastic supply. If the price of a haircut rises, barber shops and salons can hire new workers quickly. New barber shops will start, and existing businesses will stay open later.

THE BIG IDEA

The law of supply states that producers will offer more of a good if prices rise, and less of a good if prices fall.

GRAPHIC SUMMARY: Market Supply Curve

Market Supply Curve



This supply curve shows how the price of a slice of pizza affects output in a city's pizza market. Higher prices will lead pizzerias to supply more pizza.

REVIEW QUESTIONS

1. According to the law of supply, what happens to the quantity of goods produced if prices fall?
2. **Graph Skills** At the price of \$2.50, how many slices will be supplied?

TEXT SUMMARY

Economists divide a producer's costs into fixed costs and variable costs. A **fixed cost** is a cost that does not change, no matter how much is produced. Examples of fixed costs include rent and machinery repairs. A **variable cost** is a cost that rises or falls depending on the quantity produced. These include the costs of raw materials and some labor. Fixed and variable costs are added together to find **total cost**.

Businesses can increase output by hiring more workers or purchasing more capital. The change in output from adding one more worker is the **marginal product of labor**. At the beginning, adding each worker will result in **increasing marginal returns**. Workers will be able to specialize and gain skills. At some point, adding each worker will result in **diminishing**

marginal returns. Workers may need to wait to use a tool or machine. As more workers are added, there will eventually be negative marginal returns.

Marginal cost is the cost of producing one more unit of a good. **Marginal revenue** is the revenue gained from producing one more unit of a good—usually, the price of a unit. When marginal cost is less than marginal revenue, a producer has an incentive to increase output, since it will earn a profit on the next unit produced. When marginal cost is more than marginal revenue, a producer has an incentive to decrease output, since it will lose money on the next unit produced. That is why profits are maximized when marginal cost equals marginal revenue.

THE BIG IDEA

To maximize profits, businesses consider the marginal benefits of adding workers or purchasing capital.

GRAPHIC SUMMARY: Marginal Product of Labor

Labor (number of workers)	Output (beanbags per hour)	Marginal product of labor
0	0	—
1	4	4
2	10	6
3	17	7
4	23	6
5	28	5
6	31	3
7	32	1
8	31	-1

In this example, there are increasing marginal returns from adding the first three workers. As the next four workers are added there are diminishing marginal returns. The eighth worker results in negative marginal returns.

REVIEW QUESTIONS

1. Explain the difference between fixed costs and variable costs.
2. **Graph Skills** How many more bean bags per hour are produced by adding a fourth worker?

TEXT SUMMARY

Any change in the cost of inputs, like raw materials, machinery, or labor, will affect supply. A cost increase causes a fall in supply at all prices because the good has become more expensive to produce. Supply that falls at all prices can be shown as a shift to the left of a supply curve.

A fall in the cost of an input will cause an increase in supply at all price levels. An increase in supply is shown by a shift to the right of the supply curve.

The government has the power to affect the supply of many goods. A **subsidy** is a government payment to support a business or market. Since the subsidy lowers producers' costs, its effect is usually to

increase supply. The government can also reduce the supply of some goods by placing an excise tax on them. An **excise tax** is a tax on the production or sale of a good, making it more expensive to produce. **Regulation**, or steps the government takes to control production, may also affect supply.

Another influence on supply is producers' expectations. If sellers expect the price of a good to rise in the future, they will store goods now and sell more in the future. But if the price of the good is expected to drop, sellers will put more goods on the market immediately. In periods of inflation, or rising prices, producers often try to hold on to goods, reducing supply.

Changes in the costs of inputs, and government actions, can raise or lower the supply of a good at all prices.

THE BIG IDEA

Changes in the costs of inputs, and government actions, can raise or lower the supply of a good at all prices.

GRAPHIC SUMMARY: Forces that Affect Supply

Forces that Increase Supply	Forces that Decrease Supply
Decreases in production costs	Increases in production costs
Increases in technology	Excise taxes
Government subsidies	Government regulations
Expectations of future lower prices	Expectations of future higher prices
More firms entering the market	Firms leaving the market

Many different forces are at work in the market place to change the supply of goods and services.

REVIEW QUESTIONS

1. What effect does inflation often have on producers and the supply of goods?

2. **Chart Skills** How do government actions change supply?

CHAPTER 5**Test****IDENTIFYING MAIN IDEAS**

Write the letter of the correct answer in the blank provided. (10 points each)

- ____ 1. According to the law of supply,
- the lower the price the larger the quantity consumed.
 - the higher the price the larger the quantity produced.
 - if the price of a good rises some firms will produce less.
 - if the price of a good falls new firms may enter the market.
- ____ 2. A market supply curve shows
- the quantity supplied by producers at different prices.
 - supply for any set of conditions.
 - how prices affect the cost of raw materials.
 - how the supply of goods is kept in balance.
- ____ 3. Which of the following businesses has elastic supply?
- newspaper publishing
 - apple farming
 - hair cutting
 - electricity generating
- ____ 4. Which of the following is an example of a variable cost?
- rent
 - machinery repair
 - equipment
 - raw materials
- ____ 5. The change in output from adding one more worker is the
- marginal product of labor.
 - increasing marginal returns.
 - diminishing marginal returns.
 - negative marginal returns.
- ____ 6. Marginal cost is
- total revenue minus total cost.
 - total revenue plus total cost.
 - the cost of producing one more unit of a good.
 - the difference between fixed and variable costs.
- ____ 7. A producer's profits are maximized when
- marginal costs are equal to fixed costs plus variable costs.
 - marginal costs are less than marginal revenue.
 - marginal costs result in decreasing marginal returns.
 - marginal costs are equal to marginal revenue.
- ____ 8. Which of the following leads to an increase in supply?
- an increase in the cost of raw materials
 - a decrease in the cost of raw materials
 - diminishing marginal returns
 - a change in the law of supply
- ____ 9. A subsidy is
- a tax on the production or sale of a good.
 - a government payment to support a business or market.
 - a form of government regulation.
 - illustrated by the market supply curve.
- ____ 10. If sellers expect the price of a good to rise in the future, they will
- put more goods on the market immediately.
 - raise their prices now.
 - store goods now and sell more in the future.
 - set prices according to the law of demand.

CHAPTER
6

Prices

SECTION 1

COMBINING SUPPLY AND DEMAND

TEXT SUMMARY

A market **equilibrium** is the point at which quantity supplied and quantity demanded are equal. At that point, buyers are willing to buy at the same price and quantity at which sellers are willing to sell. This price is the equilibrium price. On a graph, the equilibrium point is located at the point where the supply curve and the demand curve intersect.

A market is said to be in **disequilibrium** when the quantity supplied does not equal the quantity demanded at a certain price. When quantity demanded is more than quantity supplied, there is **excess demand**. A price lower than the equilibrium price will encourage buyers and discourage sellers. Prices will rise because sellers hope to increase their profits. When quantity supplied is more than

quantity demanded, there is **excess supply**. Prices will fall because sellers need to sell their supply. Whenever there is excess in supply or demand, market forces work to create equilibrium.

Sometimes governments attempt to control prices in a market. Governments may set a **price ceiling**, a maximum price that can be charged. For example, some cities have price ceilings on rental apartments. If the price ceiling is lower than the equilibrium price, there will be excess demand. Fewer apartments are offered than people want to rent.

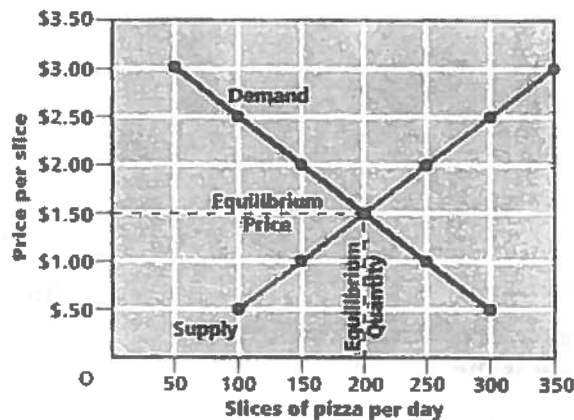
Governments may also set a **price floor**, a lowest price that can be paid. An example is the **minimum wage**, the lowest hourly rate a business can pay workers. When a minimum wage is higher than the equilibrium rate, there is excess supply of labor.

THE BIG IDEA

Markets are in equilibrium when the amount demanded is equal to the amount supplied.

GRAPHIC SUMMARY: Finding Equilibrium

Market equilibrium occurs at the price where the quantity demanded equals the quantity supplied.



REVIEW QUESTIONS

- Describe a market in equilibrium.
- Graph Skills** What is the equilibrium price and equilibrium quantity of pizza?

SECTION 2

CHANGES IN MARKET EQUILIBRIUM

TEXT SUMMARY

The previous section described disequilibrium that occurs along a demand or supply curve. If a price is higher or lower than equilibrium price, market forces push prices back towards equilibrium. Sometimes, however, changes in market conditions lead to the shift of an entire demand curve or supply curve. This means that the quantity demanded or supplied is now different at all price levels. These changes also push a market into disequilibrium, and market forces tend to bring it back to equilibrium.

Technology, for example, can make a good cheaper to produce. The earliest CD players cost about \$1,000. As technology improved, prices dropped. The supply curve shifted to the right as supply increased. Producers were now willing to offer greater quantities of CD players at all

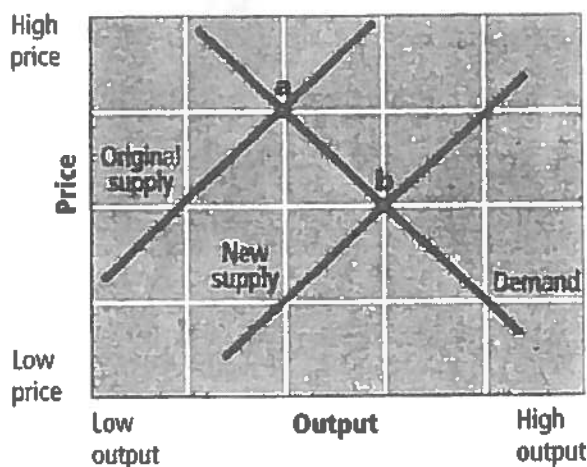
prices. However, quantity supplied was now greater than quantity demanded. Another word for this situation is **surplus**. Producers reacted to the surplus by lowering prices, and eventually price and quantity reached a new equilibrium.

An outward shift in demand can be caused by a fad, such as the surge in popularity of a new toy. Buyers want more toys than are supplied, and a **shortage** occurs. A shortage is when quantity demanded is greater than quantity supplied. During a shortage, producers and stores tend to raise prices. The market price will rise until the quantity supplied equals the quantity demanded, and a new equilibrium is established.

THE BIG IDEA

When supply or demand shifts, market price and quantity sold move towards a new equilibrium.

GRAPHIC SUMMARY: A Shift in Supply



Technological improvements led to a shift in the supply of CD players. On this graph the shift is represented by the curve marked *New supply*. Prices fell and quantity demanded rose, leading to a new equilibrium at point *b*.

REVIEW QUESTIONS

1. What is the difference between a surplus and a shortage?
2. **Graph Skills** Which has the higher price, point *a* or point *b*?

SECTION 3

THE ROLE OF PRICES

TEXT SUMMARY

Prices are like signals that send information to buyers and sellers. For producers, a high price is a signal to increase supply. A low price is a signal to reduce the supply or leave the market. For buyers, a low price is a signal to buy, and a high price is a signal to think before buying.

Rationing is a system for allocating goods and services using tools other than price. Centrally planned economies use rationing, not price, to distribute goods and services. Rationing is expensive to administer. It tends to lead to only a few products, rather than the wide variety we enjoy in our price-based system.




THE BIG IDEA
 In a free market, prices offer a flexible and efficient system for exchanging goods.

Another advantage of prices is that they are flexible. Prices can usually change more quickly than production levels. A **supply shock** occurs when there is a sudden shortage of a good, such as wheat or gasoline.

Prices do not always work efficiently in markets in which there is not much competition, or in which buyers and sellers do not have enough information. Another problem is **spillover costs**, such as air and water pollution, that "spill over" onto other people who have no control over how much of a good is produced. Producers do not usually pay spillover costs, and the extra costs will be paid by consumers.

Because supply usually cannot be increased quickly, increasing prices helps resolve excess demand.

GRAPHIC SUMMARY: Price as a Signal

	PRODUCERS		CONSUMERS	
High price	 GREEN	PRODUCE MORE	 GREEN	BUY LESS
Low price	 RED	PRODUCE LESS	 RED	BUY MORE

Price acts as a signal for both producers and consumers.

REVIEW QUESTIONS

1. Why is a change in price, instead of a change in production, usually used to resolve supply shocks?
2. **Diagram Skill** How do producers and consumers each react to higher prices?

CHAPTER 6 *Test***IDENTIFYING MAIN IDEAS**

Write the letter of the correct answer in the blank provided. (10 points each)

- ____ 1. A market is in equilibrium when
- A. quantity demanded is greater than quantity supplied.
 - B. quantity supplied is greater than quantity demanded.
 - C. quantity supplied and quantity demanded are equal.
 - D. the government takes action to bring it into equilibrium.
- ____ 2. Disequilibrium occurs when
- A. quantity supplied and quantity demanded are not equal.
 - B. quantity supplied and quantity demanded are equal.
 - C. prices are higher than quantity supplied.
 - D. there is neither excess supply nor excess demand.
- ____ 3. When there is excess supply,
- A. prices will tend to rise.
 - B. prices will tend to fall.
 - C. demand will rise.
 - D. the government will impose price ceilings.
- ____ 4. Which statement explains why prices rise in a market?
- A. Producers produce a quantity greater than consumers want to buy.
 - B. Consumers buy much less of a good than they have in previous years.
 - C. New producers enter the market.
 - D. There is excess demand in the market.
- ____ 5. The minimum wage is an example of
- A. a price ceiling.
 - B. a price floor.
 - C. the action of market forces.
 - D. market equilibrium.
- ____ 6. When does a surplus exist?
- A. when new products are brought to the market for sale
 - B. whenever prices drop
 - C. when there are too few items for the people who want to buy them
 - D. when there is a greater supply of a good than people want to buy
- ____ 7. Which of the following is an example of a shortage?
- A. Stores cannot sell all the new popular toys they have on hand.
 - B. Manufacturers make too many units of a popular new toy.
 - C. Consumers cannot find enough of a popular new toy in stores.
 - D. Consumers cannot afford to buy a new popular toy.
- ____ 8. How are goods and resources distributed in a free market economy?
- A. through rationing
 - B. through prices
 - C. through government action
 - D. through disequilibrium
- ____ 9. Rationing is a common form of distribution in
- A. a centrally planned economy.
 - B. a free market economy.
 - C. a price-based system.
 - D. a market based on competition.
- ____ 10. Which of the following is an example of spillover costs?
- A. People buy products by paying illegally high prices for them.
 - B. There is a sudden shortage of goods and the supply cannot be increased quickly.
 - C. People have to pay higher prices for items that are in short supply.
 - D. A manufacturer pollutes a river and does not pay the costs for cleaning it.

CHAPTER
7

Market Structures

SECTION 1 PERFECT COMPETITION

TEXT SUMMARY

The simplest market structure to study is one known as **perfect competition**. In such a market, every firm produces the same product for about the same price. Because each firm produces a small part of the total supply, no one firm can control the price. In order to have perfect competition a market must meet four conditions. It must have many buyers and sellers participating. Sellers must offer identical products. Buyers and sellers must be well informed about the products. Sellers must be able to enter and leave the market easily.

Only a few industries come close to meeting these conditions. Two examples are the market for farm products and the stocks traded on a stock exchange.

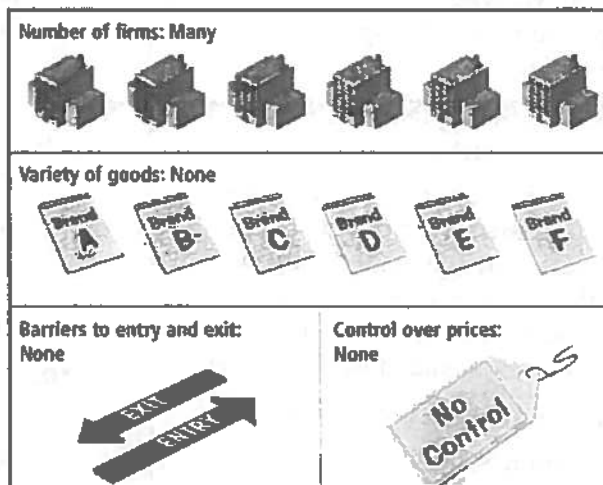
Factors that make it difficult for new firms to enter a market are called **barriers to entry**. Common barriers to entry include start-up costs and technology. **Start-up costs** are the expenses an owner has to pay before opening a new business. For example, before starting a new sandwich shop you would have to rent a store, buy cooking equipment, and print menus. Other businesses require technical ability. Carpenters, pharmacists, or electricians need training before they can have the skills they need.

Perfectly competitive markets are efficient. The intense competition in these markets keeps both prices and production costs low. A firm that raised its prices higher than other firms, or experienced higher production costs, would not be able to compete.

THE BIG IDEA

Perfect competition describes a market with many buyers and sellers of the same good.

GRAPHIC SUMMARY: A Perfectly Competitive Market



A market with these four conditions meets the economic definition of perfect competition.

REVIEW QUESTIONS

1. What are two common barriers to entry?

2. **Chart Skills** How much variety of goods is there in perfect competition?

TEXT SUMMARY

A **monopoly** is a market dominated by a single seller. Instead of many buyers and sellers, as is the case with perfect competition, a monopoly has one seller and any number of buyers. Barriers to entry make monopolies possible. Monopolies can take advantage of their monopoly power and charge high prices. For this reason, the United States has outlawed monopolistic practices in most industries.

The government allows monopolies in certain industries. A **natural monopoly** is a market that runs most efficiently when one large firm provides all the output. In the local telephone industry, a monopoly developed because it was inefficient for more than one company to build an expensive wire network. In such cases, the government may give one company the right to dominate a geographic area. In return,

that company will agree to let the government control its prices.

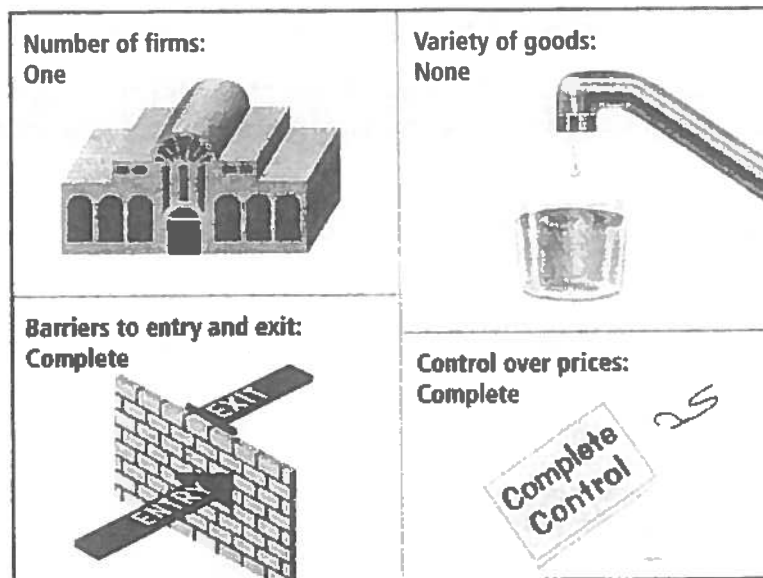
The government can also grant monopoly power by issuing patents or licenses. A **patent** gives a company exclusive rights to sell a new good or service for a specific time period. A **license** is a government-issued right to operate a business. Radio licenses give a station the right to broadcast at a certain frequency.

Unlike firms in perfectly competitive markets, monopolists have control over prices. However, the law of demand means that when the monopolist raises the price, it will sell fewer goods. So the monopolist sets a price that maximizes its profit. This usually means fewer goods, at a higher price, than would be sold in a more competitive market.

THE BIG IDEA

A firm has a monopoly when it controls an entire market.

GRAPHIC SUMMARY: A Monopoly



A monopolist dominates its market because it faces no competition.

REVIEW QUESTIONS

1. Name two ways in which government can grant a monopoly.
2. **Chart Skills** How much control does a monopolist have over pricing?

MONOPOLISTIC COMPETITION AND OLIGOPOLY

TEXT SUMMARY

Perfect competition and monopoly are the two extremes in the range of market structures. Most markets fall into two other categories: monopolistic competition and oligopoly. **Monopolistic competition** is a market in which many companies sell products that are similar but not identical. For example, jeans can differ in brand, style, and color. Ice cream differs in taste and flavors. These markets are called monopolistic

THE BIG IDEA

Most markets fall into one of two categories: monopolistic competition or oligopoly.

competition because each firm has a kind of monopoly over its own particular product. Monopolistic competition exists in industries where there are low barriers to entry.

Firms that are monopolistically competitive have slight control over their

prices, because they offer products that are slightly different from any other company's. They also use **nonprice competition**, or competition through ways other than lower prices, to compete. They may offer new colors, textures, or tastes in their products. They may also try to find the best location for their services.

Oligopoly is a market dominated by a few large firms. It can form when significant barriers to entry exist. Examples of oligopolies in the United States include air travel, cola, breakfast cereals and household appliances. Oligopolistic firms sometimes use illegal practices to set prices or to reduce competition. They may engage in **price fixing**, an agreement among firms to sell at the same or very similar prices. Price fixing is illegal in the United States and can lead to heavy penalties.

GRAPHIC SUMMARY: Comparison of Market Structures

	Perfect Competition	Monopolistic Competition	Oligopoly	Monopoly
Number of firms	Many	Many	Two to four dominate	One
Variety of goods	None	Some	Some	None
Control over prices	None	Little	Some	Complete
Barriers to entry and exit	None	Low	High	Complete
Examples	Wheat, shares of stock	Jeans, books	Cars, movie studios	Public water

The two most common market structures, monopolistic competition and oligopoly, fall between the two extremes of perfect competition and monopoly.

REVIEW QUESTIONS

1. What is the difference between monopolistic competition and oligopoly?

2. **Chart Skills** How many firms are typical of an oligopoly?

TEXT SUMMARY

Monopoly and oligopoly can sometimes have negative effects on consumers and our whole economy. Markets dominated by only a few large firms tend to have higher prices and lower output than markets with many sellers. A firm with monopoly power can use **predatory pricing**. This is the practice of setting the market price below cost to drive competitors out of business. Another way firms try to reduce competition is by buying out their competitors.

Since the late 1800s, the United States has had **antitrust laws** to prevent companies from reducing competition. It is the job of the Federal Trade Commission and the Department of Justice's Antitrust Division to enforce these laws. The government also tries to prevent mergers that might reduce competition and lead to higher prices. A **merger** is when two or more companies join to form a single firm.

In the 1970s and 1980s, Congress passed laws leading to the deregulation of some industries. **Deregulation** is the lifting or reducing of government controls over a market. Markets experiencing deregulation included the airline, electricity, banking, railroad, natural gas and television broadcasting industries. When it is successful, deregulation increases competition and leads to lower prices for consumers. However, it may often cause hardship for employees of companies driven out of business by increased competition.

Antitrust laws strengthen government control over a market. Deregulation loosens government control. Yet both policies have the same purpose: to promote competition.

THE BIG IDEA

The federal government tries to promote competition through antitrust laws and deregulation.

GRAPHIC SUMMARY: Government Actions to Encourage Competition

Year	Event
1911	Supreme Court breaks up John D. Rockefeller's monopoly, Standard Oil.
1978	Under President Jimmy Carter, federal government ends regulation of airline industry.
1982	Facing government lawsuit, AT&T agrees to end its monopoly over local phone service.
2001	President Bush reaches an agreement with Microsoft to end illegal business practices.

The federal government has taken several significant actions to increase competition in certain industries.

REVIEW QUESTIONS

1. What is predatory pricing?

2. **Chart Skills** In what year did AT&T agree to break up its local phone service monopoly?

CHAPTER 7 *Test*

IDENTIFYING MAIN IDEAS

Write the letter of the correct answer in the blank provided. (10 points each)

- | | |
|--|---|
| <p>_____ 1. A market structure with many sellers and many buyers is</p> <p style="margin-left: 20px;">A. an oligopoly.
B. monopolistic.
C. perfect competition.
D. nonprice competition.</p> <p>_____ 2. An example of a barrier to entry is</p> <p style="margin-left: 20px;">A. high start-up costs.
B. low start-up costs.
C. a market with imperfect competition.
D. government deregulation.</p> <p>_____ 3. A market that is a monopoly has</p> <p style="margin-left: 20px;">A. many buyers and sellers.
B. many firms selling slightly different products.
C. three or four firms dominating the market.
D. one seller and many buyers.</p> <p>_____ 4. A natural monopoly is a market that runs most efficiently when it has</p> <p style="margin-left: 20px;">A. few sellers and only one buyer.
B. many sellers and many buyers.
C. one large firm providing all output.
D. few government regulations.</p> <p>_____ 5. Compared to a market with perfect competition, a monopoly has</p> <p style="margin-left: 20px;">A. lower prices and fewer goods.
B. higher prices and fewer goods.
C. lower prices and more goods.
D. higher prices and more goods.</p> | <p>_____ 6. Offering products of different tastes and shapes is an example of</p> <p style="margin-left: 20px;">A. perfect competition.
B. oligopolistic competition.
C. the law of demand.
D. nonprice competition.</p> <p>_____ 7. A market that is an oligopoly has</p> <p style="margin-left: 20px;">A. many buyers and sellers.
B. many firms selling slightly different products.
C. a few firms dominating the market.
D. one seller and many buyers.</p> <p>_____ 8. Which of the following industries is not an example of an oligopoly?</p> <p style="margin-left: 20px;">A. automobile repair
B. cola
C. air travel
D. breakfast cereals</p> <p>_____ 9. One role of the federal government's Justice Department is to</p> <p style="margin-left: 20px;">A. encourage price fixing.
B. break up monopolies.
C. provide businesses with loans for start-up costs.
D. eliminate barriers to entry.</p> <p>_____ 10. In many industries, deregulation has resulted in</p> <p style="margin-left: 20px;">A. safer products.
B. antitrust laws.
C. lower prices for consumers.
D. increased government control.</p> |
|--|---|

Business Organizations

CHAPTER

8

SECTION 1

SOLE PROPRIETORSHIPS

TEXT SUMMARY

One of the first decisions entrepreneurs must make is what kind of business organization they will have. A **business organization** is an establishment formed to carry on commercial enterprise. The most common form of business organization is the sole proprietorship. A **sole proprietorship** is a business owned and run by one person. About 75 percent of all businesses in the United States are sole proprietorships. However, since most sole proprietorships are small, they account for only 6 percent of all United States sales. Your local bakery, barber shop, and bicycle repair shop are most likely sole proprietorships.

The biggest advantage of the sole proprietorship is that the owner gets to keep all profits after paying income taxes. Another advantage is that sole proprietorships are easy to start. They can usually be opened with a small amount of

paperwork and legal expense. Owners also have complete control of their businesses, and can respond quickly to changes in the marketplace.

The most important disadvantage of sole proprietorships is unlimited personal liability. **Liability** is the legal obligation to pay debts. If the business fails, the owner may have to sell personal property to cover those debts. Another disadvantage is that it may be hard for sole proprietors to find capital to expand their businesses. It may also be hard to find good employees. That is because many small businesses cannot afford **fringe benefits**, or payments to employees other than wages, such as paid vacation, retirement pay, and health insurance.

THE BIG IDEA

Sole proprietorships are the most common form of business in the United States. Owners have both full control and unlimited liability.

GRAPHIC SUMMARY: Sole Proprietorships—Advantages and Disadvantages

Advantages	Disadvantages
Ease of starting up	Lack of permanence
Full control	Unlimited liability
Sole receiver of profit	Limited access to resources and labor

Sole proprietorships offer owners the advantages and disadvantages that come with full control of a business.

REVIEW QUESTIONS

1. Explain why sole proprietorships generate only 6 percent of sales in the United States, yet are the most common form of business organization.

2. **Chart Skills** What are the disadvantages of a sole proprietorship?

SECTION 2

PARTNERSHIPS

TEXT SUMMARY

A **partnership** is a business organization owned by two or more persons. The partners must agree on how profits and responsibilities are divided. The most common type of partnership is a **general partnership**. Partners in a general partnership share equally in both responsibility and liability. Doctors, lawyers, accountants and other professionals often form general partnerships. In a **limited partnership** only one partner is required to be a general partner. That partner has control over the business, but unlimited personal liability for the firm's actions. Other partners contribute only money. A newer type of partnership is the **limited liability partnership (LLP)**. In this type of partnership all partners are limited partners and are

shielded from personal liability in certain situations.

One important advantage of a partnership is that the responsibility for the business may be shared. In a successful partnership, each partner brings different strengths and skills to the business. Each partner's **assets**, or money and other valuables, improve the firm's ability to borrow funds for operations or expansion. Another advantage of partnerships is that like sole proprietorships, they are easy to start.

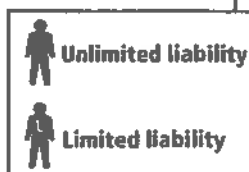
Partnerships also have disadvantages. Each general partner is responsible for the acts of the other partners. Unless the partnership is an LLP, at least one partner has unlimited liability. Like a sole proprietor, partners can lose their own personal property in paying the firm's debts. Another potential problem is conflict among the partners. They need to come to agreement about business goals and philosophies.

THE BIG IDEA

In partnerships, individuals pool their resources and share responsibility for running a business.

GRAPHIC SUMMARY: Partnerships and Liability

Partnerships vary in the amount of exposure partners have to unlimited liability.



REVIEW QUESTIONS

1. How does a limited partnership differ from a general partnership?
2. **Diagram Skills** Which kind of partnership offers none of the partners protection from unlimited liability?

CORPORATIONS, MERGERS, AND MULTINATIONALS

TEXT SUMMARY

Most large businesses in the United States are corporations. A **corporation** is a legal entity, or being, owned by individual stockholders. Each stockholder has limited liability for the firm's debts, and can lose only as much as he or she has invested. Stockholders own **stocks**, which represent their share of ownership in the corporation. Like a person, a corporation pays taxes, can enter into contracts, and can bring lawsuits in court. All corporations have the same basic structure. Stockholders elect a board of directors. The board makes the important decisions for the corporation. It also appoints corporate officers who run the corporation.

The most important advantage of the corporate structure is limiting liability. Stockholders can only lose the amount of money they have invested. Corporations can raise money by selling stock on the stock market. Corporations

also borrow money by selling **bonds**. Bonds are certificates corporations issue, promising to repay the money they borrow with interest.

As a corporation grows, it may decide to merge, or combine, with another company or companies. **Horizontal mergers** join two or more firms in the same market. For example, two automakers may decide to form a larger company. **Vertical mergers** join two or more firms involved in different stages of making the same good or service. For example, an automaker may merge with the company that supplies it with rubber tires. **Conglomerates** combine companies which produce completely unrelated goods or services. **Multinational corporations (MNCs)** are corporations that operate in more than one country at a time.

THE BIG IDEA

Corporations are complex business organizations which offer limited liability to their owners, individual stockholders.

GRAPHIC SUMMARY: Corporations—Advantages and Disadvantages

ADVANTAGES	DISADVANTAGES
<ul style="list-style-type: none"> As owners, stockholders have limited liability. Corporation can sell stocks to raise money. Corporations can borrow money by selling bonds. Corporations can continue doing business after death of founders or owners. 	<ul style="list-style-type: none"> Corporations pay a tax on income, and stockholders also pay personal income tax on payments made to them by corporations. Corporations are difficult and expensive to start. Founders may lose control of the company. Managers and directors do not always act in the best interest of stockholders. Corporations are subject to more government regulations than other kinds of businesses.

A major advantage of a corporation is that it protects its owners from liability.

REVIEW QUESTIONS

1. Who are the owners of a corporation?

2. **Chart Skills** What kinds of tax payments are associated with a corporation?

TEXT SUMMARY

A **business franchise** is a business that is semi-independent. It pays fees to a parent company. In return, the business gets the exclusive right to sell a certain product or service in a given area. The parent company, or franchiser, develops the products and business system and helps the local franchise owners produce and sell their products. For a small business owner, a franchise has the advantage of a built-in reputation. However, the franchise owner must give up some freedom, and must also pay fees and even a share of earnings.

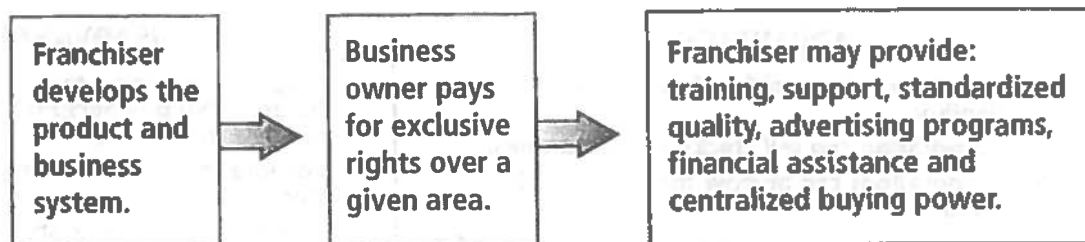
A **cooperative** is a business organization owned and operated by a group of people for their shared benefit. **Consumer cooperatives** sell merchandise to their members at reduced prices.

Cooperatives that provide a service rather than goods are called **service cooperatives**. Some service cooperatives offer discounted insurance, banking services, health care, legal help, or baby-sitting services. **Producer cooperatives** are agricultural marketing cooperatives that help members sell their products.

Nonprofit organizations function like businesses but do not operate for profit. These nonprofit organizations are usually in the business of serving society. Nonprofit organizations include museums, public schools, and YMCAs. The government exempts nonprofit organizations from income taxes. Many nonprofit organizations operate with partial government support. Nonprofit organizations that promote the interests of particular industries are called **trade associations**.

THE BIG IDEA

Different types of business organizations include franchises, cooperatives, and non-profit organizations.

GRAPHIC SUMMARY: The Relationship between Franchiser and Business Owner

A franchise owner gets support from a parent company that may include training, standardized quality, and national advertising, as well as a ready-made reputation.

REVIEW QUESTIONS

1. What is a cooperative?
2. **Diagram Skills** What does a business owner purchase when paying a fee to a franchiser?

CHAPTER 8 *Test***IDENTIFYING MAIN IDEAS**

Write the letter of the correct answer in the blank provided. (10 points each)

- _____ 1. The most common form of business organization is
A. the corporation.
B. the sole proprietorship.
C. the general partnership.
D. the franchise.
- _____ 2. Liability is the
A. necessity to do a lot of paper work.
B. requirement to offer fringe benefits.
C. legal obligation to pay debts.
D. opportunity of the sole proprietor to keep all profits after taxes.
- _____ 3. A partnership is a business organization owned by
A. one or more individuals.
B. two or more individuals.
C. individuals and stockholders.
D. one general partner and many stockholders.
- _____ 4. In a limited liability partnership, all partners
A. always have no liability.
B. have personal liability.
C. are required to be general partners.
D. are limited from personal liability in certain situations.
- _____ 5. Most large businesses are
A. sole proprietorships.
B. general partnerships.
C. corporations.
D. cooperatives.
- _____ 6. The most important decisions in a corporation are made by
A. the investors.
B. the stockholders.
C. the board of directors.
D. the founders of the company.
- _____ 7. One of the ways a corporation can raise money is by
A. selling stock on the stock market.
B. buying bonds from other corporations.
C. seeking money from the government for research and development.
D. selling shares to the founders.
- _____ 8. Which of the following is an example of a merger?
A. An individual buys a franchise.
B. Two individuals form a partnership.
C. A company combines with a company that supplies it with raw materials.
D. A company sells bonds to raise money for expansion.
- _____ 9. In return for a fee to a franchiser, a business owner receives the right
A. to sell the franchiser's stocks and bonds.
B. to run the business in the way he or she wishes.
C. to form a partnership with the franchiser.
D. to sell the franchiser's goods and services.
- _____ 10. Museums, public schools, and YMCAs are all
A. exempt from paying income taxes.
B. completely supported by the government.
C. promoted by trade associations.
D. supported by professional organizations.

CHAPTER
9

Labor

SECTION 1

LABOR MARKET TRENDS

TEXT SUMMARY

Economists define the **labor force** as nonmilitary workers over 16 who are employed or unemployed. People who are not looking for work, such as students, full-time parents, and retirees, are not considered part of the labor force.

One trend in the U. S. economy is the shift from manufacturing to services. Production of services is increasing faster than the production of goods—especially in computer-related fields.

Another important trend is the increasing numbers of women in the workplace. Changing social roles have encouraged many women to gain education and employment skills.

A third trend is the rise of **contingent employment**, or temporary work. Firms use contingent employment to gain flexibility and to save money. It is easier to discharge temporary workers than permanent employees, so firms can quickly adjust the number of workers to increase or decrease output.

American workers are paid well compared to people in some countries. However, the average earnings of college graduates has increased, while the average earnings of those without college degrees has decreased by a large amount. One reason for this is that competition from foreign companies has decreased the demand for low-skilled workers.

THE BIG IDEA

Employers are hiring more women and temporary workers as the economy shifts from manufacturing to services.

GRAPHIC SUMMARY: Composition of the U.S. Labor Force



The Bureau of Labor Statistics defines who is in the U. S. labor force.

REVIEW QUESTIONS

- Which part of the American economy is growing faster, manufacturing or services?
- Diagram Skills** Which two categories make up the total U.S. labor force?

TEXT SUMMARY

In a competitive labor market, the price of labor—the wage rate—is determined largely by supply and demand. Workers are paid according to their **productivity**, the level of output produced. Competitive demand for labor drives wages up. Some firms attempt to cut labor costs by substituting machines for people. Labor supply comes from households. The higher the wage, the larger the quantity of labor supplied. The **equilibrium wage** is the wage rate that produces neither an excess supply of workers nor an excess demand for workers.

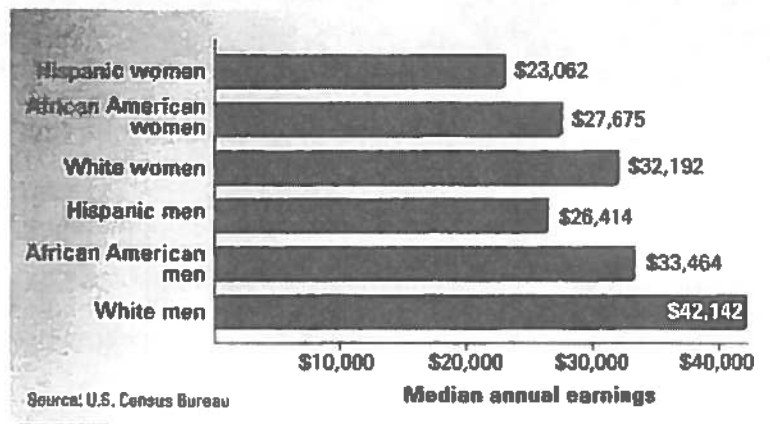
Jobs can be classified into four skill levels. **Unskilled labor** requires no specialized skills or training. **Semi-skilled labor** requires minimal specialized skills and education. **Skilled labor**

requires specialized skills and training. **Professional labor** requires advanced skills and education. Workers with higher skill levels usually receive higher wages. In addition, union members tend to earn higher wages than nonunion workers in similar jobs.

In the 1960s, Congress outlawed wage discrimination based on gender or race. Yet women still earn about 75 percent of men's earnings, and minorities tend to earn lower pay than whites. The **glass ceiling**, an unofficial and invisible barrier in some workplaces, prevents some women and minorities from advancing in certain companies.

THE BIG IDEA

In the labor market, wages are determined mostly by supply and demand.

GRAPHIC SUMMARY: Median Earnings of U. S. Workers**REVIEW QUESTIONS**

1. What determines wage rates in the labor market?
2. **Graph Skills** According to the graph, which group has the highest earnings?

SECTION 3

ORGANIZED LABOR

TEXT SUMMARY

The labor union movement, which took shape over more than a century, was largely a response to changes brought on by the Industrial Revolution and the dangerous conditions and long hours of new factory jobs. Samuel Gompers, who founded the

American Federation of Labor in 1886, focused on three reforms: higher wages, shorter hours, and safer work environments. Union membership peaked in the 1940s. In 1947, in an effort to curb union power, Congress passed the Taft-Hartley Act, which allowed states

to pass right-to-work laws. Since the 1940s, overall union membership has dropped to 13.5 percent of the labor force.

In a union workplace, management and labor periodically come together to negotiate employment contracts for wages and benefits, working conditions, and job security using the process of **collective bargaining**. If a deadlock occurs, the union members may vote to **strike**—a process that may be damaging to both labor and management. Sometimes the two sides agree to mediation in which a third party is asked to find a solution both parties will accept. However, **mediation** is not binding. If it fails, the talks may go to **arbitration** in which the third party's decision is legally binding.

THE BIG IDEA

Labor unions were created to improve working conditions for their members.

GRAPHIC SUMMARY: Economic Changes Affect Unions

MANUFACTURING DECLINES	MORE WOMEN WORK	JOBS MOVE SOUTH
From 1959 to 2003, manufacturing fell from 28% to 13% of GDP.	From 1960 to 2003 the number of women in the labor force increased from 37% to 47%.	From 1958 to 1998 the North lost 18% and the South gained 46% of manufacturing jobs.
Historically, most union jobs are in manufacturing.	Women tend to work in non-union white-collar jobs.	Historically, the South is less friendly to unions.

These structural changes in the U. S. economy may have contributed to reducing membership.

REVIEW QUESTIONS

1. What is the purpose of a labor union?
2. **Chart Skills** Which of the three economic changes appears to have had the greatest influence on union membership?

CHAPTER 9 *Test*

IDENTIFYING MAIN IDEAS

Write the letter of the correct answer in the blank provided. (10 points each)

- _____ 1. What was one reason union membership rose in the 1930s?
- A. Congress outlawed the closed shop.
 - B. Congress passed pro-union laws.
 - C. The AFL and CIO reunited.
 - D. The AFL was founded.
- _____ 2. A labor union is an organization that
- A. requires all workers to become members.
 - B. tries to improve wages and benefits for its members.
 - C. has been declared illegal by the courts.
 - D. usually has the same goals as a company's management.
- _____ 3. Collective bargaining means that
- A. representatives of unions and companies negotiate new contracts.
 - B. workers go out on strike to gain their objectives.
 - C. the courts decide how much companies will pay workers.
 - D. the unions always gain all their goals.
- _____ 4. Which of the following people is considered part of the labor force?
- A. an army sergeant
 - B. a 14-year-old with an after-school job
 - C. a person who has lost a job but is looking for one
 - D. a mother raising her children at home
- _____ 5. What is meant by productivity?
- A. the level of output produced
 - B. the kind of product a company makes
 - C. the wages paid to a worker
 - D. replacing workers with machines
- _____ 6. When is there an equilibrium wage?
- A. when Congress sets a new minimum wage
 - B. when the demand for labor exceeds the supply
 - C. when there is no excess in the demand for workers or in the supply of workers
 - D. when the supply of labor exceeds the demand
- _____ 7. Which of the following people is likely to earn the highest wage?
- A. an unskilled worker
 - B. a semi-skilled worker
 - C. a skilled worker
 - D. a professional worker
- _____ 8. What type of work is growing fastest in the United States?
- A. heavy manufacturing
 - B. information-related
 - C. agriculture
 - D. teaching
- _____ 9. Another name for temporary work is
- A. contingent employment.
 - B. service employment.
 - C. the glass ceiling.
 - D. unskilled labor.
- _____ 10. Which of the following most accurately describes the change in average weekly earnings since 1980?
- A. Average weekly earnings have dropped for everyone.
 - B. Average weekly earnings have risen sharply for everyone.
 - C. Average weekly earnings have risen for college-educated workers.
 - D. Average weekly earnings have soared for people without college degrees.

CHAPTER
10

Money and Banking

SECTION 1 **MONEY**

TEXT SUMMARY

Money is anything that serves as a medium of exchange, a unit of account and a store of value. A **medium of exchange** is anything used to measure value during the exchange of goods and services. As a **unit of account** money is a way to compare the value of goods and services. Money can also be used as a **store of value**. This means

money keeps its value if you hold on to it. The coins and paper bills used as money in a society are called **currency**. Currency must have six characteristics: durability, portability, divisibility, uniformity, scarcity, and acceptability. It must have durability, or be able to withstand a

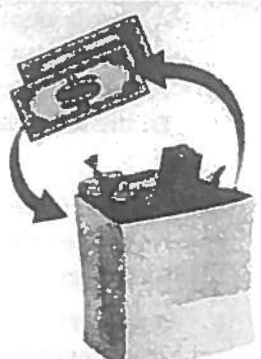
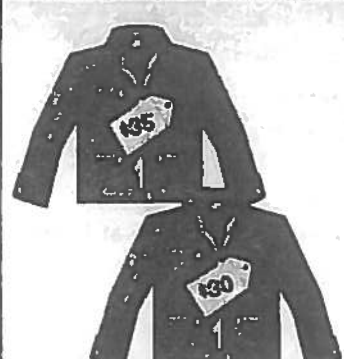

lot of use. It must have portability, or be easily carried and transferred. It must be divisible, or easily divided into smaller units. It must have uniformity, meaning that people must be able to count and measure money accurately. Currency must exhibit scarcity, meaning it must have a controlled supply. Finally, it must have acceptability, the ability to be accepted by all people in society.

Representative money represents an object of value for which it can be exchanged. For example, paper receipts for gold or silver were an early form of representative money. The United States today uses **fiat money**. This type of money has value because the government states that it is an acceptable means to pay debts.

THE BIG IDEA

Money serves as a medium of exchange, a unit of account, and a store of value.

GRAPHIC SUMMARY: The Three Functions of Money

Medium of Exchange	Unit of Account	Store of Value
		

Money has three basic uses. It enables people to exchange goods and services. It provides a way to compare prices of goods and services. It allows people to store value if they hold on to it instead of using it.

REVIEW QUESTIONS

1. Explain the difference between representative money and fiat money.
2. **Chart Skills** Which are the three functions of money?

THE HISTORY OF AMERICAN BANKING

TEXT SUMMARY

A **bank** is an institution for receiving, keeping, and lending money. In 1791, Congress set up the Bank of the United States. It lent money to the federal government and issued bank notes, a form of representative money backed by gold and silver. The Bank brought stability to American banking. However, many people were opposed to it. They worried that a centralized bank would respond only to the needs of wealthy individuals and large businesses. It ceased to exist in 1811, when its charter, or license, expired. A second central bank had the same fate, expiring in 1836. The period between 1837 and 1863 is known as the Free Banking Era. This period was dominated by state-chartered banks. Many did not have enough gold and silver to back their paper money.

During the Civil War, Congress enacted important bank reforms. These laws gave the federal government the power to charter banks. Banks were now required to hold adequate gold and silver reserves. The government also established a uniform national currency.

In 1913, Congress established the **Federal Reserve System**. It served as the nation's first true **central bank**, or bank that can lend to other banks in times of need. In the 1930s, the severe economic decline called the **Great Depression** led to new laws regulating banks. One established the **Federal Deposit Insurance Corporation (FDIC)**, which insures customer deposits if a bank fails.

THE BIG IDEA

Banking in the United States has shifted between centralized and decentralized systems, leading to the stable banking system of today.

GRAPHIC SUMMARY: Developments in American Banking

Date	Development
1780s	Federalists and Antifederalists disagree about a banking system.
1791	First Bank of the United States is established.
1811–1816	Period of instability follows expiration of First Bank's charter.
1816	Second Bank of the United States reestablishes stability.
1830s–1860s	President Jackson vetoes recharter of Second Bank in 1832, giving rise to Free Banking Era.
1861–1863	Civil War makes clear the need for a better monetary and banking system.
1863–1864	National Banking Acts of 1863 and 1864 establish national banking system and uniform national currency.
1907	Panic of 1907 leads to creation of the Federal Reserve System.
1913	President Wilson signs the Federal Reserve Act.
1929	The Great Depression begins.
1933	President Roosevelt helps restore confidence in the nation's banks by establishing the FDIC.
1980s	Period of deregulation; S & L's face bankruptcies.
2000s	Banks emerge healthy after two decades of mergers.

The modern American banking system began to take shape with the creation of the Federal Reserve System in 1913 and the Great Depression reforms of 1933.

REVIEW QUESTIONS

1. What is the purpose of the Federal Deposit Insurance Corporation?
2. **Chart Skills** What events led to the creation of the Federal Reserve System?

TEXT SUMMARY

The **money supply** is all the money available in the United States economy. The money supply is divided into categories called M1 and M2. M1 is money that people can easily use to pay for goods and services, such as currency and deposits in checking accounts. These are assets that have **liquidity**, which means they can be used as cash or easily turned into cash. M2 consists of all the assets in M1 plus several other assets which have less liquidity, such as savings accounts and **money market mutual funds**. These are funds that pool money from small investors to purchase government or corporate bonds.

The basic service banks provide is a safe way for people to store and save money.

Banks offer savings accounts, checking accounts, money market accounts and certificates of deposit. Most of these accounts pay **interest**, the price paid for the use of borrowed money. Banks also provide loans, mortgages, and credit cards. A **mortgage** is a loan used for real estate. When banks lend money, they make a profit by charging interest. The borrower also has to repay the **principal**, the amount borrowed.

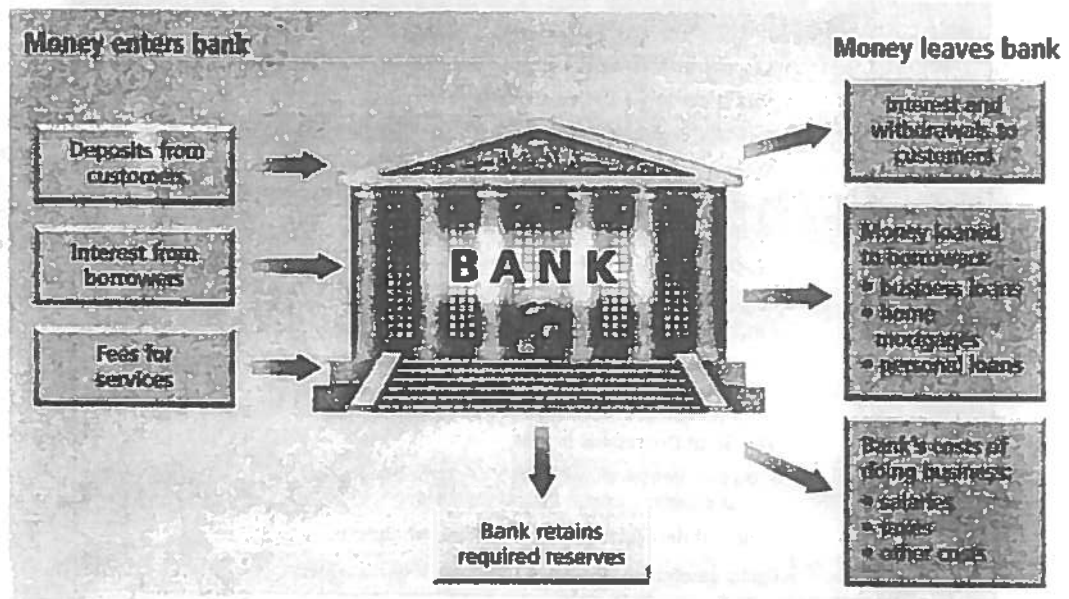
Computers are rapidly changing the world of banking. Automated Teller Machines (ATMs) are computers that customers can use to deposit money, withdraw cash, and obtain information. Many people are starting to use the Internet to handle their finances. A growing number of financial institutions allow people to check account balances, transfer money between accounts, and pay their bills by computer.

THE BIG IDEA

Over the years banks have added more services. Today the Internet and the computer have made it easier for people to manage their money.

GRAPHIC SUMMARY: How Banks Make a Profit

Although banks use the money they get from depositors for loans, they are required by law to set aside a certain amount of money as reserves.



REVIEW QUESTIONS

1. What are included in the two categories of the money supply?

2. **Diagram Skills:** What are the three ways that money enters a bank?

CHAPTER 10 *Test***IDENTIFYING MAIN IDEAS**

Write the letter of the correct answer in the blank provided. (10 points each)

- _____ 1. Which of the following is NOT a use of money?
- A. as a medium of exchange
 - B. a unit of account
 - C. a store of value
 - D. a means of barter
- _____ 2. Uniformity of currency means that it is
- A. easily divided.
 - B. easy to count and measure.
 - C. accepted by everyone in society.
 - D. scarce.
- _____ 3. Representative money gets its value from the fact that
- A. it represents objects of value for which it can be exchanged.
 - B. it is backed up by silver or gold.
 - C. the government states that it is an acceptable means to pay debts.
 - D. it is a valuable commodity.
- _____ 4. The United States today uses which kind of currency?
- A. representative money
 - B. fiat money
 - C. scarce money
 - D. gold and silver
- _____ 5. A bank is an institution
- A. owned by merchants.
 - B. that collects taxes for the government.
 - C. for receiving, keeping, and lending money.
 - D. that regulates interstate commerce.
- _____ 6. The Free Banking Era between 1837 and 1863 was dominated by
- A. federal banks.
 - B. state-chartered banks.
 - C. savings and loan banks.
 - D. the Bank of the United States.
- _____ 7. The nation's first true central bank was the
- A. Federal Reserve System.
 - B. Federal Deposit Insurance Corporation.
 - C. Bank of the United States.
 - D. federally-chartered bank of the Civil War.
- _____ 8. Assets that have liquidity are
- A. easy to borrow or lend.
 - B. easy to convert to silver and gold.
 - C. easy to turn into cash.
 - D. difficult to turn into cash.
- _____ 9. The most basic service a bank provides is
- A. a safe way to store and save money.
 - B. to pay interest.
 - C. to provide credit cards.
 - D. to provide mortgages.
- _____ 10. ATMs are computers that are
- A. used to buy merchandise on the Internet.
 - B. used to obtain mortgages.
 - C. used to make long-distance telephone calls.
 - D. used by customers to conduct their banking business.

CHAPTER
11

Financial Markets

SECTION 1 *SAVING AND INVESTING*

TEXT SUMMARY

Investment promotes economic growth. **Investment** is the act of redirecting resources from being used today so that they can create future benefits. The

THE BIG IDEA

Investment, the key to economic growth, is made possible by a financial system of savers, borrowers, and intermediaries.

financial system makes investment possible by allowing the transfer of money between savers and borrowers. Savers are households and businesses that lend out their savings. Borrowers are governments and businesses who use the money they borrow to build roads, factories, and homes. Borrowers

may also use these funds to develop new products or provide new services.

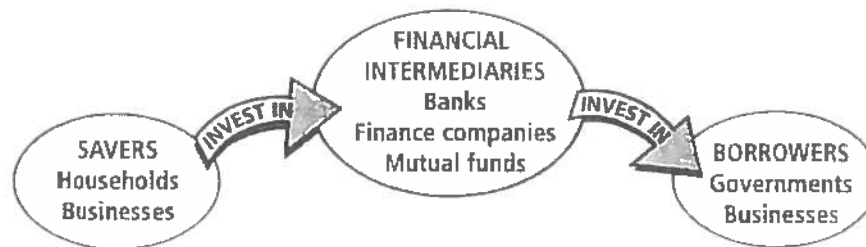
Financial intermediaries are institutions which help channel funds from savers to borrowers. Examples include banks and **mutual funds**, funds which pool savings from many people and

invest this money in different ways. Financial intermediaries provide three major advantages to investors. They reduce risk by helping people invest in a variety of opportunities. The idea of spreading out investments to reduce risk is called **diversification**. Financial intermediaries also provide information and liquidity to investors.

Saving and investing involves trade-offs. For example, savings accounts have very low risk, and are liquid, but they also have a low return. **Return** is the money, such as interest, an investor receives above and beyond the sum of money initially invested. An investment with higher risk or less liquidity usually offers a higher potential return. Investors will be more tempted to take on more risk, or to give up liquidity, if they have a chance of earning more money on their investment.

GRAPHIC SUMMARY: *Market Supply Curve*

The financial system makes possible the transfer of money between savers and borrowers.



REVIEW QUESTIONS

1. How does a financial system make investment possible?
2. **Diagram Skills** What are three examples of financial intermediaries?

SECTION 2

BONDS AND OTHER FINANCIAL ASSETS

TEXT SUMMARY

Bonds are loans that the government or a corporation must repay to an investor. Bonds usually pay a fixed amount of interest at regular intervals for a set amount of time. At **maturity**, the end of that period, the issuer repays the **par value**, or the original amount of investment, to the bondholder.

Investors like bonds because they are good investments and usually have low risk. However, because bonds are low-risk investments, their returns are often less than those of other investments. Issuers like bonds because once the bond is sold interest rates on that bond will not go up or down. However issuers must make fixed interest payments and repay the principal when due—even in bad years.

There are several types of bonds. **Savings bonds** are issued by the United

States government. The United States Treasury Department issues **treasury bonds**, and state and local governments and municipalities issue **municipal bonds**. Interest on government-issued bonds is exempt from certain taxes. Corporations sell **corporate bonds** to raise money to expand their businesses.

Other types of financial assets include certificates of deposit (CDs) and mutual funds. Markets for financial assets are often classified according to the length of time for which funds are lent. **Capital markets** are markets in which money is lent for longer than a year. **Money markets** are markets in which money is lent for less than a year.

THE BIG IDEA

Corporations and governments borrow money by selling bonds and other financial assets.

GRAPHIC SUMMARY: Types of Bonds

TYPE	ISSUER	RISK	TAX EXEMPTION	USED FOR
Savings and Treasury Bonds	U.S. Government	Very low	Exempt from state and local taxes	Federal government activities
Municipal bonds	State and local governments	Low	Exempt from income taxes at federal level and in issuing state	State and local government activities
Corporate bonds	Corporations	Moderate	Not tax exempt	Expansion of businesses
Junk bonds	Corporations	High	Not tax exempt	Finance corporate takeovers

Bonds help businesses expand and governments build public works. There are different kinds of bonds to serve different needs and different kinds of investors.

REVIEW QUESTIONS

- How is interest on bonds usually paid?
- Chart Skills** What is one purpose of junk bonds?

TEXT SUMMARY

By selling stock, corporations raise the money that is necessary to start their businesses and keep them growing. Investors in stocks may make a profit in two ways: by receiving dividends, a payment made by corporations to stockholders; and by selling the stock for more than they paid for it. The difference is called a **capital gain**. However, purchasing stock is risky. The stock price may decrease. Investors who sell their stock for less than they paid for it experience a **capital loss**.

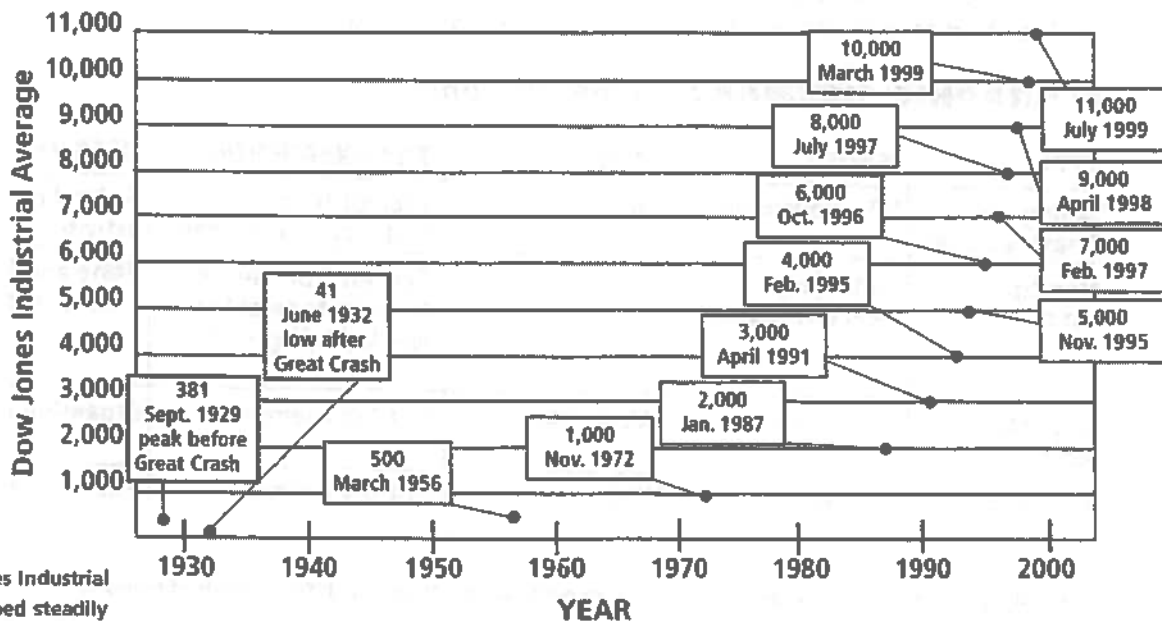
Stock is bought and sold in markets called stock exchanges. When people talk about "the stock market" they

usually mean the New York Stock Exchange (NYSE), the largest in the country. The performance of the NYSE is often measured by the performance of the few stocks included in the Dow Jones Industrial Average, or "**The Dow**." When the stock market rises steadily over a period of time, a **bull market** exists. When it falls for a period of time, people call it a **bear market**. During the bull market of the 1920's, there was a great amount of **speculation**, high-risk investment with borrowed money in hope of big returns. This period ended in the stock market collapse called the "Great Crash" of October 1929. Another great bull market occurred in the 1990s and ended in 2000.

THE BIG IDEA

Corporations sell stock to investors in order to raise money. Stocks are traded in markets called stock exchanges.

GRAPHIC SUMMARY: Milestones in the Dow Jones Industrial Average, 1929–2005



The Dow Jones Industrial Average climbed steadily since the Great Depression of the 1930s before rising sharply in the bull market of the 1990's.

REVIEW QUESTIONS

1. What is the difference between a capital gain and a capital loss?
2. **Graph Skills** When did the Dow Jones Industrial Average reach its lowest point after the Great Crash?

CHAPTER 11 *Test***IDENTIFYING MAIN IDEAS**

Write the letter of the correct answer in the blank provided. (10 points each)

- ____ 1. Investment is the act of
A. depositing money in a savings account.
B. redirecting resources from being used today so they can create future benefits.
C. using resources for current needs.
D. developing new products.
- ____ 2. A financial system brings together
A. savers and borrowers.
B. savers and consumers.
C. banks and mutual funds.
D. governments and businesses.
- ____ 3. The purpose of a financial intermediary is to help channel funds
A. from one bank to another.
B. from saving bonds to building projects.
C. from savers to borrowers.
D. from stocks to bonds.
- ____ 4. Which of the following is a reason for diversification?
A. to get the highest possible return
B. to get the most dividends
C. to eliminate risk
D. to reduce risk
- ____ 5. Bonds are
A. loans.
B. dividends.
C. stocks.
D. certificates of deposit.
- ____ 6. A bond's par value is generally repaid
A. after 30 years.
B. when the lender demands it.
C. at maturity.
D. when interest rates change.
- ____ 7. Which of these bonds are issued by the United States government?
A. corporate bonds
B. savings bonds
C. junk bonds
D. municipal bonds
- ____ 8. Investors who sell stocks for less than they paid for them experience a
A. capital gain.
B. capital loss.
C. return on investment.
D. negative dividend.
- ____ 9. When the stock market falls over a period of time, it is known as a
A. bear market.
B. bull market.
C. crash.
D. depression.
- ____ 10. Speculation is
A. low-risk investment with borrowed money in hope of small returns.
B. high-risk investment with borrowed money in hope of big returns.
C. investment of large amounts of money in mutual funds.
D. diversifying purchases of stock into many different kinds of companies.

CHAPTER
12

Gross Domestic Product and Growth

SECTION 1 GROSS DOMESTIC PRODUCT

TEXT SUMMARY

Economists study economic performance using **national income accounting**, a system of collecting statistics on the economy. The U.S. Department of Commerce collects this data in the form of National Income and Products Accounts (NIPA).

The most important NIPA measure is **gross domestic product (GDP)**, the dollar value of all final goods and services produced in a country's borders in a given year.

GDP does not include **intermediate goods**, goods used to produce final goods. For example, the price of a new house that is sold is included in GDP, but not the nails and lumber used to build that house. GDP includes goods produced in the country by a foreign company, but not goods that an American company produces in another country.

Changing prices can distort GDP. To correct this, economists determine **real GDP**, GDP expressed in constant, or unchanging, prices.

Another important NIPA measure is **gross national product (GNP)**. GNP includes income earned by U.S. companies outside of the country, but does not include the income earned by foreign firms doing business in the country.

As you might expect, supply and demand affect GDP. Economists calculate the **price level**, the average of all prices, to determine **aggregate supply**, the total amount of goods and services in the economy available at all possible price levels. **Aggregate demand** is the amount of goods and services in the economy that will be purchased at all possible price levels. The intersection of aggregate supply and aggregate demand on a graph indicates the equilibrium price level of the economy.

THE BIG IDEA

Economists monitor the nation's economic performance using gross domestic product (GDP) and other measures.

GRAPHIC SUMMARY: Measurements of the Macroeconomy

Gross Domestic Product	+	income earned outside U.S. by U.S. firms and citizens	=	income earned by foreign firms and foreign citizens located in the U.S.	=	Gross National Product
Gross National Product	-	depreciation of capital equipment	=		=	Net National Product
Net National Product	-	most business taxes	=		=	National Income
National Income	-	<ul style="list-style-type: none"> • firms' reinvested profits • firms' income taxes • social security 	+	other household income	=	Personal Income
Personal Income	-	individual income taxes	=		=	Disposable Personal Income

Various measures are used by economists to track changes in the nation's economy.

REVIEW QUESTIONS

1. What is GDP?
2. **Diagram Skills** Explain the difference between gross domestic product and gross national product.

TEXT SUMMARY

A **business cycle** is a period of economic expansion followed by a period of contraction. Business cycles are major changes in GDP above or below normal levels. Business cycles have four phases. **Expansion** is a period of economic growth, as measured by a rise in real GDP. The **peak** is the height of expansion, when real GDP stops rising. A **contraction**, marked by falling real GDP, follows the peak. The **trough** is the contraction's lowest point, when real GDP stops falling. A contraction that lasts for at least 6 months is called a **recession**. A **depression** is a long and severe recession.

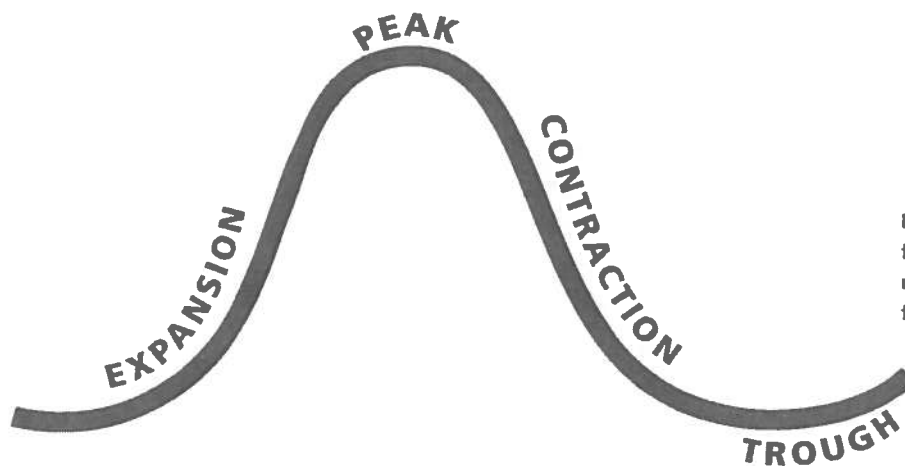
Business cycles are affected by four main factors: business investment, interest rates and credit, consumer expectations, and external shocks that are unexpected.

For example, increased business investment usually leads to increased output and jobs, helping to increase GDP and expand the economy. However, a drop in business spending reduces output and income, which may lead to a decline in GDP. Economists study these factors in order to predict the next turn of the business cycle.

Economic activity in the United States has followed a pattern of cycles. The Great Depression, which began in 1929, was the most severe economic downturn. Since then there have been several recessions, including short ones in 1991 and 2001. Following the 2001 recession the economy entered a period of slow and uneven growth.

THE BIG IDEA

Policymakers study business cycles to try to predict the next phase of the economy.

GRAPHIC SUMMARY: Tracking a Business Cycle

Business cycles have four phases, which are measured by the rise or fall of the GDP.

REVIEW QUESTIONS

1. Explain how business investment may affect business cycles.
2. **Diagram Skills** What happens after a peak in a business cycle?

TEXT SUMMARY

The basic measure of a nation's economic growth rate is the percentage change of real GDP over a given period of time. A nation's population tends to grow. Real GDP must keep up with the population growth rate. The best measure of a nation's standard of living is **real GDP per capita**. That divides the nation's real GDP by the number of people it has (per capita means per person). Real GDP per capita lets economists compare economies for different time periods and different nations.

Physical capital contributes to an economy's output and aids economic growth. **Capital deepening**, the process of increasing the amount of capital per worker, is an important

source of growth in modern economies. Increases in human capital also lead to economic growth. Better educated workers can produce more output per hour of work.

An economy increases its capital through saving and investment. **Saving** is income that consumers do not spend to purchase goods and services. Money that is saved, which may be held in a bank, is then available for investment. The **savings rate** is the proportion of disposable income spent to income saved. In the long run, a higher savings rate means more growth in real GDP.

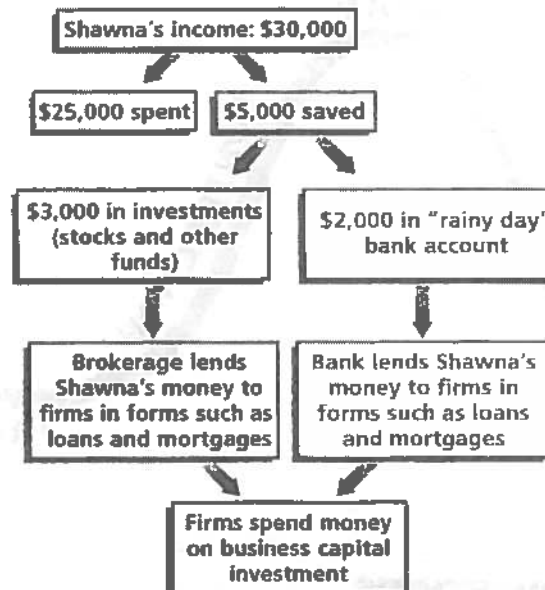
Besides capital deepening, the other key source of economic growth is **technological progress**. This is an increase in efficiency gained by producing more output without using more inputs.

THE BIG IDEA

Economic growth is a steady, long-term increase in a nation's real GDP that tends to raise living standards.

The money people save becomes available to businesses for investment. Higher savings leads to higher output, raising GDP and living standards.

GRAPHIC SUMMARY: How Saving Leads to Capital Deepening



REVIEW QUESTIONS

1. What is capital deepening?
2. **Diagram Skills** How do firms make use of borrowed money?

CHAPTER 12 *Test*

IDENTIFYING MAIN IDEAS

Write the letter of the correct answer in the blank provided. (10 points each)

- | | |
|---|---|
| <p>_____ 1. The most important measure in national income accounting is</p> <p style="margin-left: 20px;">A. intermediate goods.
B. final goods.
C. gross national product.
D. gross domestic product.</p> <p>_____ 2. Real GDP</p> <p style="margin-left: 20px;">A. distorts the price level in the GDP.
B. expresses GDP in constant prices.
C. measures only intermediate goods.
D. is another term for GNP.</p> <p>_____ 3. Which of the following is included in GDP?</p> <p style="margin-left: 20px;">A. an intermediate good
B. A service produced and used in another country
C. a fish that you catch and eat yourself
D. a fish that you buy at a store</p> <p>_____ 4. The average of all prices in the economy is the</p> <p style="margin-left: 20px;">A. aggregate supply.
B. aggregate demand.
C. price level.
D. gross national product.</p> <p>_____ 5. What is a business cycle?</p> <p style="margin-left: 20px;">A. a period of increased economic growth
B. a period of economic growth followed by economic contraction
C. the amount of time it takes a business to produce its products
D. a dangerous time for all businesses</p> | <p>_____ 6. The period in a business cycle when real GDP stops falling is</p> <p style="margin-left: 20px;">A. expansion.
B. peak.
C. contraction.
D. trough.</p> <p>_____ 7. What is a recession?</p> <p style="margin-left: 20px;">A. a period when real GDP falls for at least 6 months
B. a long and severe depression
C. a very mild and short expansion
D. a period of when the economy is neither expanding nor contracting</p> <p>_____ 8. What is the best measure of a nation's standard of living?</p> <p style="margin-left: 20px;">A. real GDP per capita
B. population growth
C. savings
D. national income</p> <p>_____ 9. An increase in capital is called</p> <p style="margin-left: 20px;">A. human capital.
B. the savings rate.
C. capital deepening.
D. economic output.</p> <p>_____ 10. Technological progress leads to</p> <p style="margin-left: 20px;">A. an increase in efficiency.
B. a decrease in efficiency.
C. a loss of interest in human capital.
D. lower savings rates.</p> |
|---|---|

CHAPTER
13

Economic Challenges

SECTION 1

UNEMPLOYMENT

TEXT SUMMARY

Economists examine four kinds of unemployment. **Frictional unemployment** occurs when people are in between jobs or returning to the work force after a period of not working. **Seasonal unemployment** occurs in industries that slow or shut down for a particular time of the year, such as after a harvest or a busy holiday season. **Structural unemployment** happens when workers' skills do not match the jobs that are available. For example, new technology may cost jobs in industries that rely on older ways of producing goods. **Cyclical unemployment** occurs during recessions, when the demand for goods and services drops. The resulting slowdown in production causes the demand for labor to drop, and companies lay off employees.

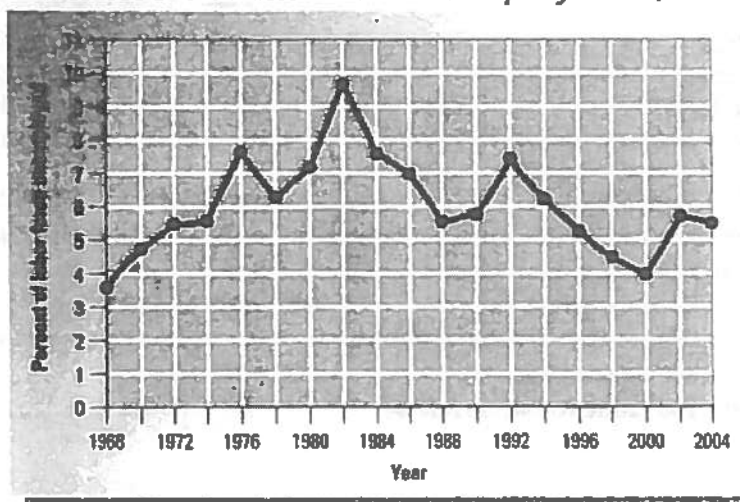
THE BIG IDEA

The amount and types of unemployment are a measure of the health of the entire economy.

The amount of unemployment is an important clue to the health of the nation's economy. The federal government tracks the **unemployment rate**, or the percentage of the nation's labor force that is unemployed. To determine the unemployment rate, the Bureau of Labor Statistics polls a large sample of the population every month.

Since frictional, seasonal, and structural employment occur even in an economy that is working properly, economists expect some unemployment. An unemployment rate of 4 to 6 percent is considered **full employment**, the level of employment reached when there is no cyclical unemployment. However, some people with jobs are **underemployed**, meaning that they work part time when they want full-time jobs, or work at jobs that are below their skills.

GRAPHIC SUMMARY: Unemployment, 1968—2004



Source: U.S. Department of Labor

After a recession in 1991, the unemployment rate dropped throughout much of the 1990s and rose in the early 2000s.

REVIEW QUESTIONS

1. Why do economists expect there to be some unemployment in the economy?
2. **Graph Skills** What was the highest unemployment rate between 1968 and 2004? In which year did it occur?

TEXT SUMMARY

Inflation is a general increase in prices. In a period of inflation, as prices rise, the same amount of money buys less. Inflation reduces people's **purchasing power**, their ability to buy goods and services. To track inflation, economists use a **price index**, a measurement that shows how the average price of a standard group of goods changes over time. The best known is the **Consumer Price Index (CPI)**. The CPI measures the prices of a **market basket**—a representative collection of goods and services used by a typical urban consumer. Economists will calculate the change in the CPI from year to year to determine the **inflation rate**, the percentage change in prices over time.

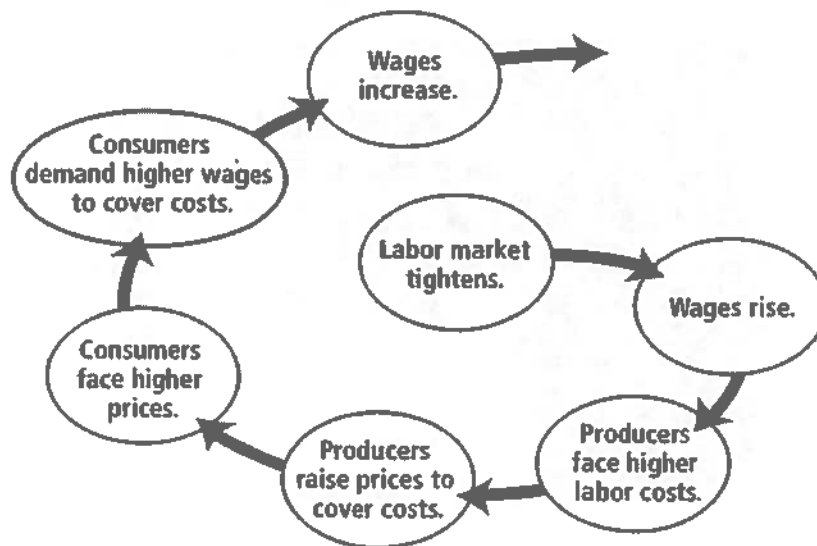
Economists offer three reasons for why inflation begins. The **quantity theory** states that too much money in the economy leads to inflation. According to

the **demand-pull theory**, inflation occurs when demand for goods and services exceeds existing supplies. Finally, the **cost-push theory** states that inflation occurs when producers raise prices in order to meet increased costs for labor and raw materials. Cost-push inflation can lead to a **wage-price spiral**. This is the process by which increases in one type of prices can cause other prices to rise.

Typically, when unemployment falls to very low levels, inflation tends to increase. The supply of available workers shrinks and wages rise. In the early 2000s, the economy had a period of slow growth. Some economists predicted a period of **deflation**, or a sustained drop in the price level. The economy recovered, however, and inflation remained low.

THE BIG IDEA

Rising prices and the inflation rate can affect wages, purchasing power, and many other aspects of daily life.

GRAPHIC SUMMARY: Tracking a Business Cycle

This diagram shows one example of the wage-price spiral. Rising wages can push up the inflation rate.

REVIEW QUESTIONS

1. How do economists track inflation?

2. **Diagram Skills** What causes producers to raise their prices?

SECTION 3

POVERTY

TEXT SUMMARY

The government defines a poor family as one whose total income is less than the amount needed to satisfy minimal needs. The U.S. Census Bureau determines the **poverty threshold**, the income level below that which is needed to support a household or family. This threshold varies with family size. In 2004, the threshold was \$12,490 for a single parent with one child, and \$18,850 for a family of four with two children. The **poverty rate** is the percentage of people who live in households below the poverty threshold. The poverty rate varies among different groups. Among African Americans or Latinos, it is twice as high as for white Americans.

discrimination based on race and gender. Many poor people live in areas such as inner cities or isolated rural areas, where there are few high-paying jobs. Other causes of poverty include economic slow-downs and the increasing number of single-parent families.

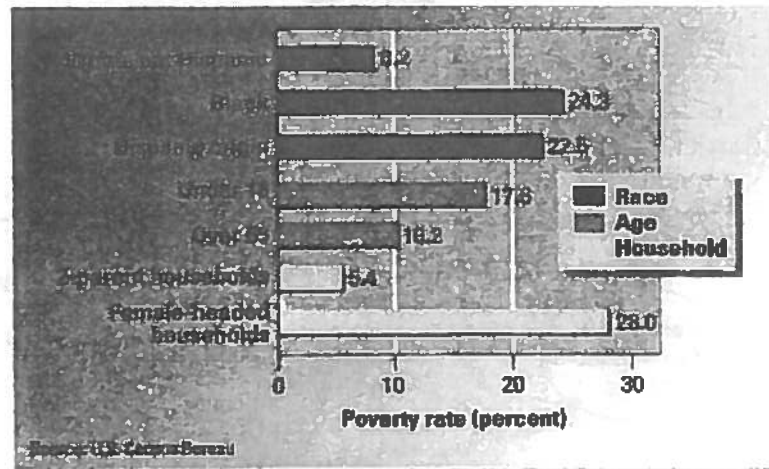
The United States has millions of poor people, but it also has the world's highest per capital GDP. This is because **income distribution**, the way income is distributed among the population, is unequal. The richest 20 percent of the population has more than 13 times the income of the poorest 20 percent. The government spends billions of dollars on programs designed to reduce poverty. **Enterprise zones**, for example, are low-employment areas where companies can locate free of certain taxes.

THE BIG IDEA

Despite the success of the American economy, millions of people remain poor.

GRAPHIC SUMMARY: Poverty Rates for Different Population Groups

Families in some groups are more likely to have incomes below the poverty threshold.



REVIEW QUESTIONS

1. What is the poverty threshold?
2. **Graph Skills** What is the poverty rate for people under 18? For female-headed households?

CHAPTER 13 *Test*

IDENTIFYING MAIN IDEAS

Write the letter of the correct answer in the blank provided. (10 points each)

- _____ 1. When a farm worker loses his job after the harvest, it is an example of
- frictional unemployment.
 - seasonal unemployment.
 - structural unemployment.
 - cyclical unemployment.
- _____ 2. Which statement describes full employment?
- Everybody who wants a job has a job.
 - There is no unemployment at all.
 - There is no cyclical unemployment.
 - There is no structural unemployment.
- _____ 3. People who are underemployed
- no longer look for work.
 - work part time or at jobs that are below their skills.
 - are the same as unemployed workers.
 - experience only frictional employment.
- _____ 4. A general increase in prices is called
- inflation.
 - purchasing power.
 - the CPI.
 - a price index.
- _____ 5. The inflation rate is
- the ability to buy goods or services.
 - measured in fixed dollars.
 - not an important measure to economists.
 - the percentage change in prices over time.
- _____ 6. Inflation reduces people's purchasing power because
- the same amount of money buys more goods and services.
 - the same amount of money buys fewer goods and services.
 - the market basket has to be changed every year.
 - there is not enough money in the economy.
- _____ 7. What is the poverty threshold?
- the income level below that which is needed to support a family
 - the income of the lowest 20 percent of families
 - the percentage of people who live in poverty
 - the income needed to live in an inner city or rural area
- _____ 8. Poverty rates are
- higher for whites than for African Americans.
 - higher for whites than for Latinos.
 - higher for African Americans and Latinos than whites.
 - the same for all racial groups.
- _____ 9. Which of the following statements describes income distribution in the United States?
- Most people earn the same income.
 - The richest 20 percent of the population has about 20 percent of the national income.
 - The richest 20 percent of the population has a much greater share of income than the poorest 20 percent.
 - The richest 20 percent of the population has slightly more income than the poorest 20 percent.
- _____ 10. An enterprise zone is
- a wealthy part of a city where everybody has a good job.
 - a part of a city with many old, closed factories.
 - a government office where people can work in exchange for temporary assistance.
 - an area of high unemployment where the government encourages companies to locate by providing tax breaks.

CHAPTER
14

Taxes and Government Spending

SECTION 1

WHAT ARE TAXES?

TEXT SUMMARY

Taxes are payments that people are required to pay to a local, state, or national government. Taxes supply **revenue**, or income, to provide the goods and services that people expect from government.

The Constitution grants Congress the power to tax and also limits the kinds of taxes Congress can impose. Federal taxes must be for the "common defense and general welfare," must be the same in all states, and may not be placed on exports. The Sixteenth Amendment, ratified in 1913, gave Congress the power to levy an income tax.

When government creates a tax, it decides on the type of **tax base**—the income, property, good, or service that is

subject to a tax. It also decides how to structure the tax. The three basic kinds of tax structures are proportional, progressive, and regressive. A **proportional tax** is a tax in which the percentage of income paid in taxes remains the same for all income levels. A **progressive tax** is one in which the percentage increases at higher income levels. An example is the **individual income tax**, a tax on a person's income, which requires people with higher incomes to pay a higher percentage of their incomes in taxes. In a **regressive tax**, the percentage increases at lower income levels. A **sales tax**, a tax on the value of a good or service being sold, is regressive because higher-income people pay a lower proportion of their incomes on goods and services.

THE BIG IDEA

Government collects money to run its programs through different types of taxes.

GRAPHIC SUMMARY: Three Types of Tax Structures

Type of Tax	Description	Example	Ron's taxes on \$50,000 income	Mary's taxes on \$150,000 income
Proportional	A constant percentage of income is taken in taxes as income increases	"Flat" tax	\$7,500, or 15 percent of income	\$22,500, or 15 percent of income
Progressive	A larger percentage of income is taken in taxes as income increases	Income tax	\$5,000, or 10 percent of income	\$45,000, or 30 percent of income
Regressive	A smaller percentage of income is taken in taxes as income increases	Sales tax	\$2,000, or 5 percent of total purchases of \$40,000; tax bill is 4 percent of income	\$3,000, or 5 percent of total purchases of \$60,000; tax bill is 2 percent of income

Each type of tax structure places different kinds of burdens on people of different income levels. This chart shows how different tax structures would affect two taxpayers: Ron, with an income of \$50,000, and Mary, with an income of \$150,000.

REVIEW QUESTIONS

1. What is meant by the term tax base?
2. **Chart Skills** Does Ron or Mary pay more tax dollars with a sales tax? Which person pays a larger percentage of income with a sales tax?

SECTION 2

FEDERAL TAXES

TEXT SUMMARY

The federal government has several sources of income. The largest is the individual income tax, which provides nearly half of federal revenue. It is collected on a "pay-as-you-earn" system throughout the year, mostly by employers **withholding**, or taking out part of an employee's income and sending it to the federal government. At the end of the year employers send employees a report showing how much has been withheld. Employees then fill out a **tax return**, a form in which people declare income to the government and figure out how much tax must be paid.

Taxable income is a person's gross, or total, income minus exemptions and deductions. Gross income includes income from salaries, wages, tips, and commissions, as well as from interest on savings accounts and stock dividends. Personal exemptions are set amounts that can be subtracted for an individual and for

family members. **Deductions** include interest on a mortgage, donations to charity, and state and local taxes.

Corporations pay a corporate income tax on their income. Corporate taxes make up about 10 percent of federal revenues. Like personal income taxes, corporate taxes are progressive. Tax rates increase as profits increase.

The Federal Insurance Contributions Act, or **FICA**, taxes are also withheld from people's salaries. Most goes for **Social Security**, which was established in 1935 as a retirement fund for workers. Now it also provides benefits to wage earners' surviving family members and people with disabilities. FICA taxes also fund **Medicare**, a national health insurance program for people over age 65.

THE BIG IDEA

The federal government receives income from families and corporations, and other types of taxes, to help fund government programs.

GRAPHIC SUMMARY: Sources of Federal Revenue

Tax	Tax Base
Personal income tax	Individuals' income
Corporate tax	Corporations' profits
FICA taxes	Individual's income, but payments shared by individuals and corporations
Excise tax	Sale of certain products, such as gasoline, alcohol, telephone service
Estate tax	The estate of a person who has died
Gift tax	Money or property one living person gives to another
Tariff	Imported goods brought into the country

Although the federal government has different sources of revenue, the largest share is paid by personal income taxes.

REVIEW QUESTIONS

- How is the corporate tax like the personal income tax?
- Chart Skills** What kind of federal tax do you pay if you fill your car with gasoline or make a telephone call?

SECTION 3

FEDERAL SPENDING

TEXT SUMMARY

The federal government takes in nearly \$2 trillion dollars a year in revenue. About three-quarters of its spending, however, is "mandatory." **Mandatory spending** is money lawmakers are required by law to spend on certain programs or to use for interest payments on the national debt.

programs include food stamps, Supplemental Security Income (SSI), and child nutrition, generally for low-income people. The federal government also pays retirement benefits and insurance for federal workers and veterans' pensions.

THE BIG IDEA

The federal government has a huge budget of nearly \$2 trillion, but much of its spending is required by law.

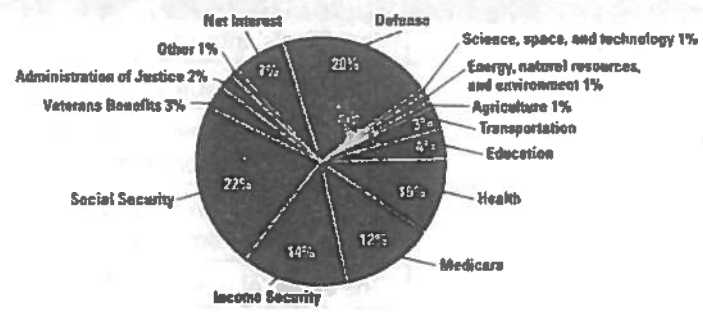
Most mandatory spending is for **entitlements**. These are benefits paid to people who meet certain requirements, such as age or income. Spending on entitlement programs rises as the number of qualified recipients rise. The largest entitlement programs are Social Security, Medicare, and Medicaid, which provides health insurance to low-income families. Other mandatory spending

Discretionary spending is spending for which government planners can make choices. It accounts for about one-quarter of federal spending. Discretionary spending includes defense spending, education, national parks and monuments, transportation, disaster aid, foreign aid, and many other items.

The federal government also provides aid to state and local governments and shares the costs for some programs with state and local governments. Medicaid costs, for example, are shared by both the federal and state governments.

GRAPHIC SUMMARY: Federal Spending

The federal government spends tax money on both mandatory programs, such as Social Security and Medicare, and discretionary programs, such as national defense and education.



Note: Because of rounding, totals may be less or greater than 100 percent.
Source: Office of Management and Budget

REVIEW QUESTIONS

1. What is the difference between mandatory and discretionary spending?
2. **Graph Skills** What percentage of federal spending is spent on Medicare? On net interest payments?

SECTION 4

STATE AND LOCAL TAXES AND SPENDING

TEXT SUMMARY

State governments have two budgets. The **operating budget** pays day-to-day expenses. The **capital budget** pays for major capital, or investment, spending. New bridges and buildings are examples of capital spending. State laws require a **balanced budget**—a budget in which revenue is equal to spending. This rule applies only to the operating budget.

While tax policies and spending differ among states, most spend the largest amounts on education, public safety, highways, and public welfare. Public safety includes state police, crime labs, and corrections systems. States also build and maintain highways and roads, often with federal assistance. States get revenue several ways. All but five states have a sales tax. States may also have excise taxes, state income taxes, taxes on **real property**, such as land and buildings,

and **personal property**, such as furniture and jewelry. Most states collect corporate income taxes and license fees.

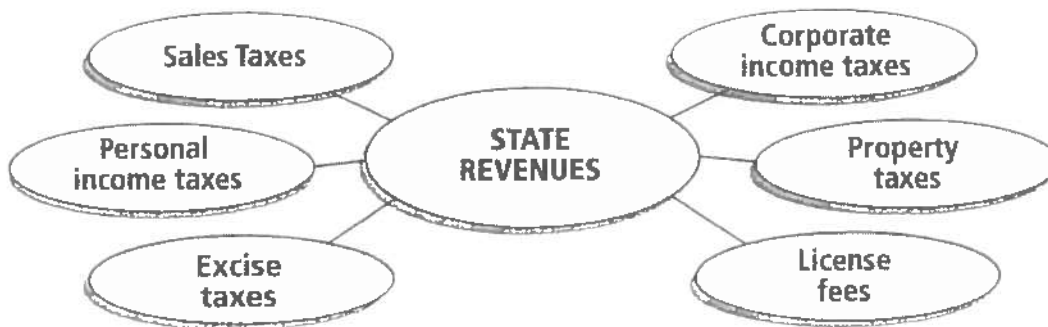
Local governments—towns, cities, townships, counties, and special districts—also collect taxes.

These taxes support public schools, law enforcement, fire protection, libraries, airports, public hospitals, parks, public transportation, and more. The main source of local revenue is property taxes, a tax on the value of a property. Property taxes are paid by people who own homes, apartments, buildings, or land. An official called a **tax assessor** determines the value of the property. Local governments may also levy sales taxes, excise taxes, and income taxes.

THE BIG IDEA

State and local governments get revenue from various taxes, as well as from the federal government, to fund programs and services.

GRAPHIC SUMMARY: Sources of State Revenues



Most states get the major part of their revenues from sales taxes and individual income taxes, but each state has its own mix of revenue sources.

REVIEW QUESTIONS

1. What is the difference between an operating budget and a capital budget?
2. **Diagram Skill** Which two sources of state revenue are taxes on income?

CHAPTER 14 *Test*

IDENTIFYING MAIN IDEAS

Write the letter of the correct answer in the blank provided. (10 points each)

- | | |
|---|---|
| <p>_____ 1. The income, property, goods, or services on which people pay tax is called a</p> <p>A. tax rate.
B. tax base.
C. sales tax.
D. revenue.</p> <p>_____ 2. Which of the following would be a progressive tax?</p> <p>A. People earning \$35,000 pay 10 percent tax, while people earning \$100,000 pay 30 percent tax.
B. People pay 10 percent on property whether it is worth \$50,000 or \$500,000.
C. All people pay a 15 percent income tax.
D. Everyone pays a 5 percent sales tax.</p> <p>_____ 3. What provides the largest portion of federal revenue?</p> <p>A. corporate taxes
B. tariffs
C. FICA taxes
D. individual income taxes</p> <p>_____ 4. What is a person's taxable income?</p> <p>A. the gross income received from salaries, wages, tips, and commissions
B. all the income that was withheld by an employer and sent to the federal government
C. a person's gross income after subtracting exemptions and deductions
D. all the personal exemptions and deductions a person has</p> <p>_____ 5. What is withholding?</p> <p>A. a statement to employees telling them how much taxes they owe.
B. a way of collecting taxes from the salaries of employees.
C. a pension paid to retired people.
D. a kind of insurance for employees who lose their jobs.</p> | <p>_____ 6. Most federal mandatory spending is spent on</p> <p>A. defense.
B. interest on the national debt.
C. salaries for people in the federal government.
D. entitlements.</p> <p>_____ 7. An example of federal discretionary spending is</p> <p>A. transportation.
B. Social Security.
C. Medicare.
D. food stamps.</p> <p>_____ 8. Which of the following would be paid for with a state's capital budget?</p> <p>A. lawmakers' salaries
B. education
C. salaries of state troopers
D. a new bridge</p> <p>_____ 9. One feature common to states is</p> <p>A. a balanced budget requirement.
B. an income tax.
C. a sales tax.
D. the same percentage of spending on Medicaid.</p> <p>_____ 10. The main source of revenue for local governments is</p> <p>A. a sales tax.
B. license fees.
C. property taxes.
D. income taxes.</p> |
|---|---|

Fiscal Policy

SECTION 1

UNDERSTANDING FISCAL POLICY

TEXT SUMMARY

Fiscal policy is the government's use of taxing and spending to keep the nation's economy stable. Decisions about fiscal policy are used to create the **federal budget**, a written document showing how much money the government expects to receive and spend in a year.

The budget process begins when each federal agency estimates spending for the next year. They send these estimates to the executive branch's **Office of Management and Budget (OMB)**. The OMB reviews proposals and, with the President's staff, combines all budgets into one document, which the President presents to Congress. Congress reviews the budget with help from the **Congressional Budget Office**. Congress then proposes its modified budget and authorizes specific spending in **appropriations bills**, which the President can sign or veto.

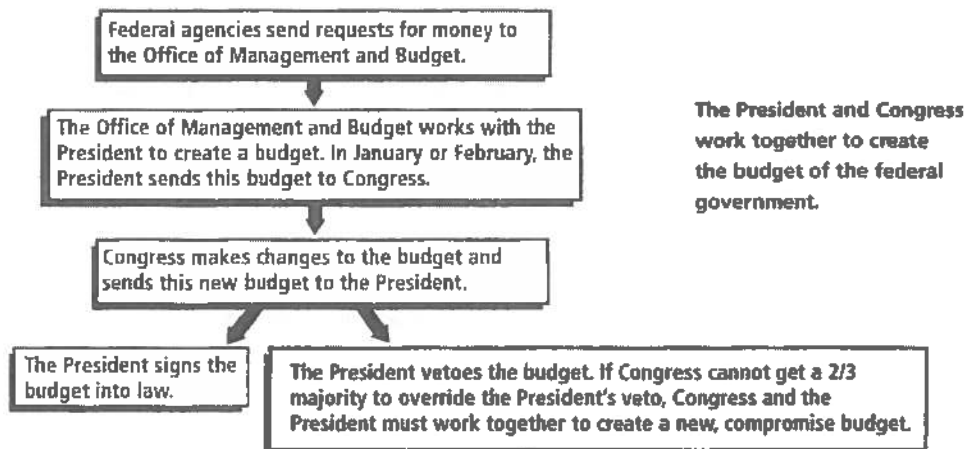
Expansionary policies are designed to increase economic output. When the government increases its spending it buys more goods and services, leading to economic growth. When government cuts taxes, people have more money to spend, a situation which also leads to economic growth. Policies intended to decrease output are **contractionary policies**. These policies allow government to decrease its spending or raise taxes, both of which will lead to slower economic growth.

Fiscal policy is not easy to put into practice. Changes in the economy come slowly. During the time it takes to pass a budget and implement fiscal policy, the business cycle may change on its own.

THE BIG IDEA

Federal government decisions on taxes, borrowing, and spending have a powerful impact on the nation's economy.

GRAPHIC SUMMARY: *Creating the Federal Budget*



REVIEW QUESTIONS

1. What are expansionary policies?
2. **Diagram Skills** What happens if the President vetoes the budget?

SECTION 2

FISCAL POLICY OPTIONS

TEXT SUMMARY

Classical economics was a school of thought stating that markets regulate themselves and will return to equilibrium without government interference. The Great Depression challenged this

and services, encouraging production, which in turn would put more people back to work.

Fiscal policy is powerful because of the **multiplier effect**, the idea that every dollar change in fiscal policy creates a greater than one dollar change in the national economy. For example, if the government buys \$10 billion in goods and services, GDP increases by more than \$10 billion because firms spend money on wages, raw materials, and investment. Workers, suppliers, and stockholders will have money to spend.

THE BIG IDEA

Different schools of economic theory provide different views about the government's role in encouraging growth.

view. Although prices fell, demand did not increase because so many people lacked jobs and money. John Maynard Keynes introduced a theory, called **Keynesian economics**, which emphasized the role of government in the

economy. Keynes said the Depression continued because neither consumers nor businesses had an incentive to increase spending. Companies would not increase production if consumers had no money to buy their products. Consumers who were unemployed had no money to spend. Keynes argued that the government could buy more goods

Supply-side economics states that taxes have a negative effect on economic output. Supply-siders argue that lower taxes put more money in people's pockets, which in turn leads to greater investment and more jobs. Under President Ronald Reagan in the 1980s, the government cut taxes and implemented supply-side policies.

GRAPHIC SUMMARY: Comparing Economic Theories

Classical Economics	Keynesian Economics	Supply-Side economics
Markets regulate themselves. As prices rise and fall, supply and demand adjust and the market returns to equilibrium.	In a recession, demand may not increase even if prices drop. If neither consumers nor businesses can spend money, the government spends more to increase aggregate demand.	Aggregate supply is more important than aggregate demand. Lower tax rates are the key to increasing aggregate supply because they make more money available to investors.

Different economic theories have different views about the government's use of fiscal policy.

REVIEW QUESTIONS

1. What is the multiplier effect?

2. **Chart Skills** Which theory advocates focuses on aggregate demand? Which focuses on aggregate supply?

SECTION 3

BUDGET DEFICITS AND THE NATIONAL DEBT

TEXT SUMMARY

When government revenues equal spending, a **balanced budget** exists. In reality, the federal budget is rarely balanced. A **budget surplus** occurs when annual revenues are higher than spending. A **budget deficit** occurs when spending is higher than revenues.

When the government runs a deficit, it must find a way to pay for the extra expenditures. It can either create money or borrow money. Covering huge deficits with created money can lead to **hyperinflation**, or very high inflation. The main way that government borrows money is by selling bonds, such as United States Savings Bonds.

When government borrows money, it creates a **national debt**, the total amount of money the government owes to bondholders. Two problems arise from a national debt. First, it reduces funds available for businesses to borrow and

invest because people buy government bonds instead of investing in business. Second, government pays interest to bondholders, and money spent paying interest cannot be spent elsewhere.

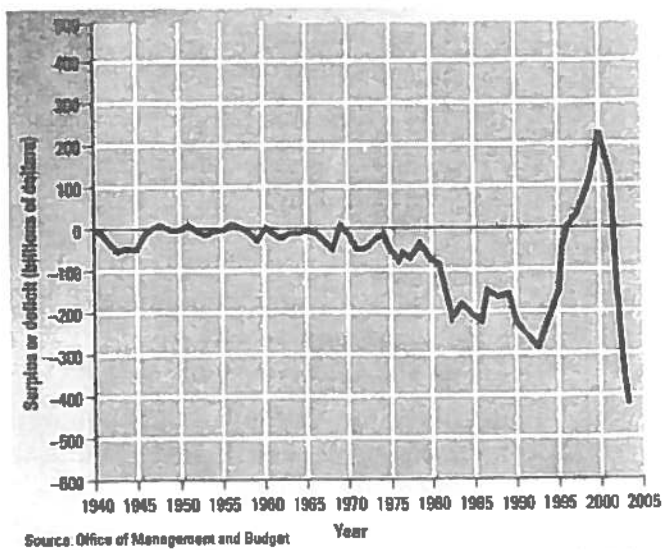
In the 1980s, huge deficits led Congress to pass laws cutting federal spending. After the Supreme Court found many of these laws unconstitutional, some people suggested amending the Constitution to require a balanced budget. Opponents said an amendment would prevent government from dealing with rapid economic changes.

At the end of the twentieth century, budget surpluses occurred for the first time in thirty years. However, war, recession, and tax cuts soon brought new deficits.

THE BIG IDEA

When the federal spending is greater than revenue, budget deficits and a national debt are the result.

GRAPHIC SUMMARY: Budget Surpluses and Deficits, 1940–2004



In the years since 1940, the United States government has had more years of budget deficits than budget surpluses.

REVIEW QUESTIONS

1. What is the difference between a budget surplus and a budget deficit?
2. **Graph Skills** When did the federal government run the largest deficit? The largest surplus?

CHAPTER 15 *Test*

IDENTIFYING MAIN IDEAS

Write the letter of the correct answer in the blank provided. (10 points each)

- | | |
|---|--|
| <p>_____ 1. What is the main goal of government's fiscal policy?</p> <p>A. to have a budget surplus
 B. to have a budget deficit
 C. to produce a balanced budget
 D. to maintain a stable economy</p> <p>_____ 2. The federal budget process begins with</p> <p>A. appropriations bills.
 B. federal agency estimates.
 C. Congress.
 D. the Congressional Budget Office.</p> <p>_____ 3. Which of the following might be part of an expansionary policy?</p> <p>A. increased taxes
 B. a tax cut
 C. lower government spending
 D. mandatory spending</p> <p>_____ 4. Classical economics states that</p> <p>A. markets should be allowed to regulate themselves.
 B. government should spend in a recession.
 C. government should cut taxes in a recession.
 D. government should raise taxes in a recession.</p> <p>_____ 5. John Maynard Keynes believed that to end the Great Depression, government should</p> <p>A. allow the markets to regulate themselves.
 B. spend and buy more goods and services.
 C. lower taxes.
 D. raise taxes.</p> | <p>_____ 6. The main idea of the multiplier effect is that</p> <p>A. government should create new money to put an end to inflation.
 B. every dollar the government spends creates a greater than one dollar change in economic output.
 C. taxes multiply each year and create a greater deficit.
 D. as the economy grows, more jobs are created.</p> <p>_____ 7. A supply-side economist would be in favor of</p> <p>A. cutting taxes.
 B. raising taxes.
 C. increasing government spending.
 D. regulating markets.</p> <p>_____ 8. When government revenues and expenditures are equal, there is</p> <p>A. a budget surplus.
 B. a budget deficit.
 C. hyperinflation.
 D. a balanced budget.</p> <p>_____ 9. The national debt is</p> <p>A. all the money individuals owe on their credit cards.
 B. the interest the government pays on bonds.
 C. the total amount of money the federal government owes.
 D. the same as a budget deficit.</p> <p>_____ 10. What was the budget situation of the federal government at the end of the twentieth century?</p> <p>A. There was no longer a national debt.
 B. The budget deficit was larger than ever.
 C. There was a budget surplus.
 D. The budget was balanced.</p> |
|---|--|

The Federal Reserve and Monetary Policy

CHAPTER 16

SECTION 1

THE FEDERAL RESERVE SYSTEM

TEXT SUMMARY

After a series of banking crises, Congress passed the Federal Reserve Act in 1913. The Federal Reserve System, often referred to as "the Fed," is a group of twelve regional independent banks. During the Great Depression, the regional banks did not always agree on what kind of action to take. In response, Congress reformed the Fed in 1935, giving it more centralized power to deal with crises such as the Great Depression.

Member banks own the Federal Reserve System. Members include all nationally-chartered banks, which are required to join, and some state-chartered banks, which may join if they wish. A **Board of Governors**, appointed by the President, oversees the Fed. To prevent the board from being influenced by politics, no one President may appoint all the governors.

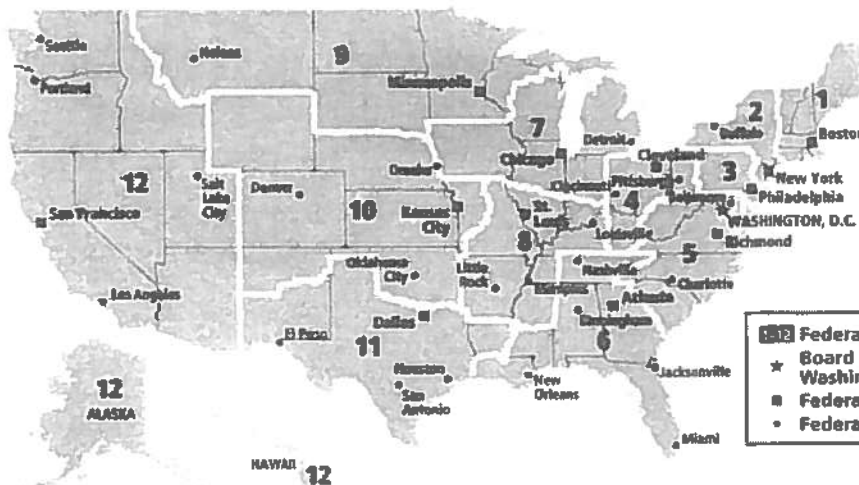
The President also appoints the Board's chair. The chair is the main spokesperson for the nation's **monetary policy**, the actions the Fed takes to influence the level of real GDP and the rate of inflation.

The Federal Reserve System is divided into twelve regional **Federal Reserve Districts**, with one regional Federal Reserve Bank in each. They monitor and report on district economic and banking conditions. The **Federal Open Market Committee (FOMC)** makes key decisions about interest rates and the growth of the U.S. money supply. Its members are drawn from the Board of Governors and the twelve district banks.

THE BIG IDEA

The Federal Reserve System was founded in 1913 to stabilize the nation's money supply and conduct monetary policy.

GRAPHIC SUMMARY: Federal Reserve Districts



The Federal Reserve System is made up of 12 districts, each with its own Federal Reserve Bank. The Board of Governors of the Fed meet in Washington, D.C.

- 12 Federal Reserve districts
- ★ Board of Governors, Washington, D.C.
- Federal Reserve Bank cities
- Federal Reserve branch cities

REVIEW QUESTIONS

1. Why did Congress adjust the Federal Reserve structure in 1935?

2. **Map Skills:** What city is home to the Federal Reserve bank of District 1?

SECTION 2

FEDERAL RESERVE FUNCTIONS

TEXT SUMMARY

The Fed provides banking services to the federal government. It maintains a checking account for the Treasury Department and processes payments, such as Social Security checks and IRS refunds. It helps the government finance its activities. When the Treasury Department auctions government bonds, the funds gained from such sales are deposited into the Federal Reserve Bank of New York. The Fed also issues paper currency and takes worn or damaged bills out of circulation.

THE BIG IDEA

The Fed serves as the nation's banker and a banker's bank, and regulates the banking system and the nation's money supply.

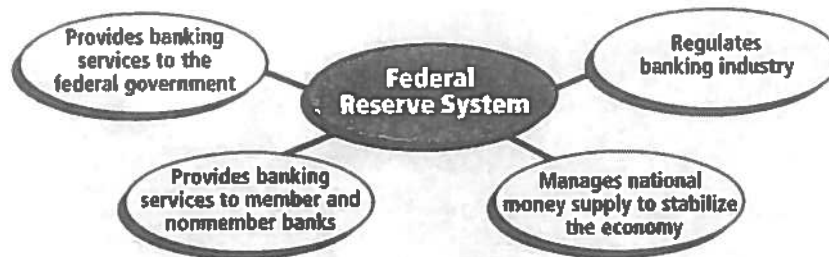
The Fed provides banking services to banks. One service is **check clearing**, the process by which banks record whose account gives up money and whose

account receives money when someone writes a check. The Fed sends out bank examiners to supervise lending practices and other activities of member banks. The Fed also protects consumers by enforcing truth-in-lending laws.

Banks often lend each other money from their reserve balances. These funds are called **federal funds**. The interest rate that banks charge each other for these is called the **federal funds rate**. Banks can also borrow directly from the Federal Reserve.

The Federal Reserve is best known for its role in regulating the nation's money supply. The law of supply and demand affects money as well as the rest of the economy. Too much money in the economy leads to inflation. Ideally, the Fed tries to increase the money supply by the same rate as the growth in the demand for money.

GRAPHIC SUMMARY: Functions of the Federal Reserve System



The twelve banks that make up the Federal Reserve system carry out functions that are critical to the health of the nation's economy and banking system.

REVIEW QUESTIONS

1. What is the discount rate?

2. **Diagram Skills** What are the four main functions of the Federal Reserve System?

TEXT SUMMARY

Money enters the economy by a process called **money creation**. Banks create money making loans. When a bank makes a loan of \$1000 and deposits money in the borrowers checking account, it increases the money supply by \$1,000. The bank can loan out all but the **required reserve ratio (RRR)**, the ratio of reserves to deposits required of banks by the Fed. If the RRR is 10 percent, the bank may loan out \$900 of the original \$1,000 deposit. The bank can then lend out 90 percent of that \$900, and so on.

The Fed has three tools for adjusting the amount of money in the economy. The simplest is to change reserve requirements. Reducing the RRR means that banks can lend out more money, increasing the money supply. Increasing RRR has the opposite effect.

A second tool is to adjust the federal funds rate. Both the discount rate and

prime rate are affected by changes in the federal funds rate. When the federal funds rate goes up or down, the other two rates also go up or down. When banks lend money at a lower rate, it tends to increase the overall money supply.

The Fed's third and most important monetary policy tool is **open market operations**, the buying and selling of government securities such as bonds. When the Fed wants to increase the money supply, it purchases government securities. The bond seller deposits money from the sale into the bank, starting the money creation process. To decrease the money supply, the Fed sells government securities. The money paid for the bond is taken out of circulation, and reserves are reduced.

THE BIG IDEA

By lending money, banks increase the money supply. The Fed uses several tools to make the money supply increase or decrease.

GRAPHIC SUMMARY: Tools of the Fed

	Changing the Required Reserve Ratio (RRR)	Changing the Federal Funds Rate	Open Market Operations
To INCREASE the money supply, other banks can...	Reduce the RRR, freeing up reserves for banks, allowing them to make more loans.	Decrease the federal funds rate, encouraging banks to borrow from other banks, increasing reserves for loans.	Buy government securities, putting money into the seller's checking account and starting the money creation process.
To DECREASE the money supply, other banks can...	Increase the RRR, reducing reserves for banks, making less money available for loans.	Increase the federal funds rate, discouraging banks from borrowing from other banks, decreasing reserves for loans.	Sell government securities, withdrawing money from the seller's account and taking it out of circulation.

The Fed has three major tools for regulating the nation's money supply. The preferred tool is open market operations, which has the least disruptive effect on the banking system.

REVIEW QUESTIONS

- How does reducing the RRR lead to an increase in the money supply?
- Chart Skills** What are the three major tools of the Fed in controlling the money supply?

SECTION 4

MONETARY POLICY AND MACROECONOMIC STABILIZATION

TEXT SUMMARY

Monetarism is the belief that the money supply is the most important factor in macroeconomic performance. Monetary policy alters the supply of money, which in turn affects interest rates. When the supply of money is low,

the price of money—the interest rate—is high. When the supply of money is high, interest rates are low.

The Fed can use monetary policy to expand or contract the U.S. economy. An **easy money policy** is a monetary policy that increases the money supply. A larger money supply means lower interest rates, which in turn means more money for investment and a boost to the economy. By contrast, a **tight money policy** is a monetary policy that reduces

the money supply by raising interest rates, thus decreasing GDP.

Timing is essential in monetary policy. Good timing smoothes out fluctuations in the business cycle. Bad timing can make the business cycle worse. For example, an expansionary policy may take effect as the economy is beginning to expand on its own, leading to overexpansion and inflation.

An **inside lag** is a delay in implementing policy. It may occur because it takes time to recognize a problem. An **outside lag** is the time for a policy to take effect. Because of lags and the difficulty of predicting the direction of the economy, it is difficult to use monetary policy effectively. Some recessions are short and correct themselves in time. Policy makers are more likely to want to intervene in the case of a long and severe recession.

THE BIG IDEA
The Fed can use monetary policy to tame business cycles, but it must decide if and when it is wise to intervene in the economy.

GRAPHIC SUMMARY: Fiscal and Monetary Policy Tools

	Fiscal policy tools	Monetary policy tools
Expansionary tools	<ol style="list-style-type: none"> 1. increasing government spending 2. cutting taxes 	<ol style="list-style-type: none"> 1. open market operations: bond purchases 2. decreasing the discount rate 3. decreasing reserve requirements
Contractionary tools	<ol style="list-style-type: none"> 1. decreasing government spending 2. raising taxes 	<ol style="list-style-type: none"> 1. open market operations: bond sales 2. increasing the discount rate 3. increasing reserve requirements

Both fiscal policy and monetary policy can be used to affect the economy.

REVIEW QUESTIONS

1. What is the difference on the money supply between an easy-money policy and a tight-money policy?
2. **Chart Skills** If the Fed is pursuing an expansionary policy, would it want to buy or sell bonds?

CHAPTER 16 *Test***IDENTIFYING MAIN IDEAS**

Write the letter of the correct answer in the blank provided. (10 points each)

- ____ 1. What is monetary policy?
- A. the amount of money the federal government spends
 - B. the amount of money that the Federal Reserve banks print up and distribute
 - C. actions the Federal Reserve System takes to influence the rate of inflation and real GDP
 - D. the decision to have federal or state banks
- ____ 2. How many Federal Reserve Districts are there?
- A. one
 - B. one for each state
 - C. three
 - D. twelve
- ____ 3. Who owns the Federal Reserve System?
- A. the federal government
 - B. member banks
 - C. all banks in the country
 - D. all commercial banks in the country
- ____ 4. What is one service the Fed performs for the Treasury Department?
- A. It processes payments, such as Social Security checks.
 - B. It auctions government bills.
 - C. It collects federal taxes.
 - D. It selects the Secretary of the Treasury.
- ____ 5. The federal funds rate is
- A. the rate banks charge when lending money to one another.
 - B. the amount that a bank has to subtract for its reserves.
 - C. a special rate that member banks of the Federal Reserve get for their financial operations.
 - D. the rate customers of savings banks get for borrowing money.
- ____ 6. How do banks create money?
- A. by getting permission to print money from the Federal Reserve
 - B. by paying interest to their customers
 - C. by selling off bank property
 - D. by loaning out money that borrowers place in their checking accounts
- ____ 7. What is the required reserve ratio?
- A. the amount of money that the Fed does not let banks borrow
 - B. the reserves that the Fed requires banks to keep from the money deposited
 - C. the interest rate banks charge each other
 - D. the money kept by the federal government
- ____ 8. What is the Fed's most important monetary policy tool?
- A. creating money
 - B. changing the federal funds rate
 - C. changing reserve requirements
 - D. borrowing money
- ____ 9. What is the main idea of monetarism?
- A. All money should be issued by the federal government.
 - B. The money supply is the most important factor in economic performance.
 - C. Interest rates are the most important factor in economic performance.
 - D. Money should be minted in gold or silver.
- ____ 10. Which of the following actions would the Fed take to fight inflation?
- A. increase government spending
 - B. raise taxes
 - C. increase the money supply
 - D. reduce the money supply

CHAPTER
17

International Trade

SECTION 1

WHY NATIONS TRADE

TEXT SUMMARY

Natural resources, human capital, and physical capital are unevenly distributed from country to country. Because countries differ so much in resources, they also differ in their ability to produce different goods and services. They will specialize in certain products that they can produce most efficiently. For example, coffee is grown more efficiently in warm areas like Central America than in other parts of the world. Because countries cannot efficiently produce everything their citizens need and want, they engage in trade.

Comparative advantage is the ability of one person or nation to produce a good at a lower opportunity cost than that of another person or nation. The **law of comparative advantage** states that

nations are better off when they produce goods and services they have a comparative advantage in supplying. The money nations make from selling those goods and service can be used to buy the goods and services they cannot produce as efficiently.

An **export** is a good sent to another country for sale. An **import** is a good brought in from another country for sale. The United States is the world's leading exporter followed by Germany and Japan. The United States is also the world's top importer.

As countries specialize in certain products in which they have a comparative advantage, changes in employment patterns can occur. For example, in the 1970s Japan gained a comparative advantage in producing automobiles. As the American automobile industry lost business, many American workers lost their jobs.

THE BIG IDEA

By specializing in the production of certain goods and services, nations make the best use of their resources.

GRAPHIC SUMMARY: Resource Distribution

	India	Peru	United Kingdom	United States
Total area (sq km)	3,287,590	1,285,220	244,820	9,629,091
Arable land (sq km)	1,664,986	38,400	60,398	1,740,202
Mineral resources	Coal, iron ore, manganese, mica, bauxite, titanium ore, chromite, natural gas, diamonds, petroleum, limestone, arable land	Copper, silver, gold, petroleum, timber, fish, iron ore, coal, phosphate, potash, hydropower	Coal, petroleum, natural gas, tin, limestone, iron ore, salt, clay, chalk, gypsum, lead, silica, arable land	Coal, copper, lead, phosphates, molybdenum, uranium, bauxite, gold, iron, mercury, nickel, potash, silver, tungsten, zinc, petroleum, natural gas, timber
Population	1.1 billion	27,949,639	59,778,002	291,765,169
Labor force	406 million	7.5 million	29.7 million	147 million
Literacy rate	52%	88.3%	99%	97%
Telephones	27 per 1,000 people	64 per 1,000 people	585 per 1,000 people	697 per 1,000 people
Airports	335	239	470	14,695

Nations have great differences in their resources and their ability to benefit from them.

REVIEW QUESTIONS

1. Why do countries trade?
2. **Chart Skills** Which country on the chart has the highest rate of literacy?

SECTION 2

TRADE BARRIERS AND AGREEMENTS

TEXT SUMMARY

Most countries have **trade barriers**—a means of preventing a foreign product or service from freely entering a country. One type of trade barrier is an **import quota**, a law limiting the amount of a good that can be imported. A **voluntary export restraint** is a limit a country imposes on itself on the amount of exports it ships to another country. A **tariff** is a tax on imported goods.

Trade barriers have both positive and negative effects. For example, United States tariffs will result in higher prices on imported cars. This helps American car makers compete. However, consumers then pay more for imported cars. American manufacturers might lose the incentive to become more efficient and make less expensive cars. **Trade wars** are another possible negative effect of trade restrictions. When one country restricts imports, its

trading partner may try to use similar restrictions. Trade wars can result in less trade.

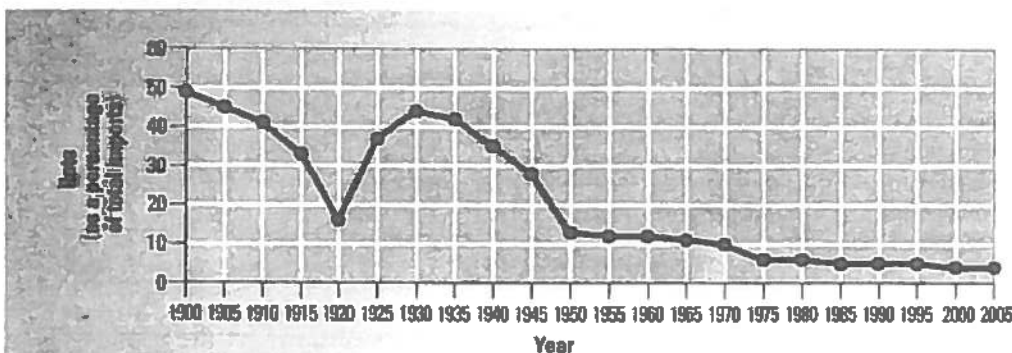
Protectionism is the use of trade restrictions to protect a nation's industries. The most basic argument for protectionism is that it protects workers in industries that would be hurt by specialization and trade.

Recent trends have been toward lowering trade barriers and increasing trade through international trade agreements. **The World Trade Organization (WTO)** attempts to negotiate agreements and resolve trade disputes. The United States has entered into a treaty called **NAFTA**, the North American Free Trade Agreement, which reduces trade barriers between the United States, Canada, and Mexico.

THE BIG IDEA

Exchange between countries can be restricted by barriers to trade.

GRAPHIC SUMMARY: Average Tariff Rates in the United States



Sources: *Historical Statistics of the United States: Colonial Times to 1970*; *Statistical Abstract of the United States*; *Trade Policy Review of the United States*

Tariffs have declined throughout most of the 1900s.

REVIEW QUESTIONS

1. Identify positive and negative effects of trade barriers.
2. **Graph Skills** In what year was the tariff rate the highest?

TEXT SUMMARY

Before you can spend money in a foreign country you have to exchange your U.S. dollars for the currency of that nation. The value of that currency in relation to your own is the **exchange rate**. Exchange rates go up and down daily. An

increase in the value of a currency is called **appreciation**. When a nation's currency appreciates, its products become more expensive to other nations, leading to a decrease in its exports. However, its imports become cheaper and usually increase in number. The opposite happens with **depreciation**, a decrease in the value of a nation's currency.

The **foreign exchange market**, which consists of about 2,000 banks and other financial institutions, helps companies and nations exchange currencies,

thus making international trade possible. The world's countries work together to compare and keep track of exchange rates. A **fixed exchange-rate system** keeps the value of currencies constant against one another. Since 1973 the United States and many governments have adopted a **flexible exchange-rate system**, which allows exchange rates to be determined by supply and demand. Some European countries, members of the European Union, use the same currency, called the **Euro**, and the same central bank.

The relationship between imports and exports is called **balance of trade**. A **trade surplus** occurs when a nation exports more than it imports. A **trade deficit** occurs when a nation imports more than it exports. The United States had a large trade deficit in the 1990s and 2000s.

THE BIG IDEA

International trade requires exchange rates, which compare the values of the world's different currencies.

GRAPHIC SUMMARY: Foreign Exchange Rates

Currency	Value of \$1 U.S.
Australian dollar	1.281
United Kingdom pound	0.525
Canadian dollar	1.244
Japanese yen	104.4
European Union euro	0.772
Mexican peso	10.935
Chinese renminbi	8.277

Foreign exchange rates change every day. According to this chart, one U.S. dollar can be exchanged into about one and a quarter Canadian dollars.

REVIEW QUESTIONS

- Which system do the United States and many other countries use to compare exchange rates between their currencies?
- Chart Skills** How many yen can be exchanged for one U.S. dollar?

CHAPTER 17 *Test***IDENTIFYING MAIN IDEAS**

Write the letter of the correct answer in the blank provided. (10 points each)

- _____ 1. Nations specialize when they
- A. have few natural resources.
 - B. produce certain goods and services more efficiently than others.
 - C. import more than they export.
 - D. export more than they import.
- _____ 2. Comparative advantage is the ability of a country to
- A. have more physical capital than another.
 - B. produce everything its people need and want.
 - C. produce a good at a lower opportunity cost than another country.
 - D. borrow more money from other countries.
- _____ 3. Which statement illustrates the law of comparative advantage?
- A. A country makes the goods it produces most efficiently and trades for others.
 - B. A country makes all the goods it needs.
 - C. A country buys all its goods from other nations.
 - D. A country exports all its raw materials and imports all manufactured products.
- _____ 4. What is the purpose of import quotas?
- A. to increase the amount of certain imported goods
 - B. to decrease the amount of certain imported goods
 - C. to lower trade barriers
 - D. to create a self-imposed limitation on imports
- _____ 5. A tariff is a tax on
- A. raw materials.
 - B. exported goods.
 - C. imported goods.
 - D. any form of international trade.
- _____ 6. The most basic argument in favor of protectionism is that it
- A. protects workers.
 - B. protects consumers.
 - C. defends nations against trade wars.
 - D. helps a country's currency appreciate.
- _____ 7. Which of the following is an example of a trade war?
- A. Two countries reduce all trade restrictions on each other.
 - B. Two countries compete to see which can produce the most of a certain good.
 - C. Consumers in two countries refuse to buy the goods of the other country.
 - D. Two countries impose tariffs on each other's products.
- _____ 8. Recent trends toward trade restrictions have been to
- A. lower only those trade barriers related to technology.
 - B. shield a country's automobile industries.
 - C. increase trade barriers.
 - D. decrease trade barriers.
- _____ 9. When a nation's currency appreciates, which is the most likely result?
- A. Its exports and imports will increase.
 - B. Its exports and imports will decrease.
 - C. Its exports will increase and its imports will decrease.
 - D. Its exports will decrease and its imports will increase.
- _____ 10. A country that imports more than it exports has a
- A. trade deficit.
 - B. trade surplus.
 - C. balance of trade.
 - D. export quota.

CHAPTER
18

Economic Development and Transition

SECTION 1 LEVELS OF DEVELOPMENT

TEXT SUMMARY

Development is the process by which a nation improves its people's economic, political, and social well-being.

Developed nations, such as the United States, have a high average level of material well-being. Most nations are **less developed countries (LDCs)**, with low levels of material well-being.

The primary measure of level of development is **per capita gross domestic product (per capita GDP)**—a nation's gross domestic product (GDP) divided by its total population. For example, Australia and India have similar GDPs. However, India has about 50 times as many people, so it has a much lower per capita GDP. Another way to measure development is the amount of energy, such as oil and gas, used per person. Most developed nations

have high levels of **industrialization**, the extensive organization of an economy for the purpose of manufacture. Countries with a high level of industrialization use large amounts of oil and electricity. By contrast, most LDCs use less amounts of energy per person, since large numbers of people engage in **subsistence agriculture**. They raise only enough food to feed their families.

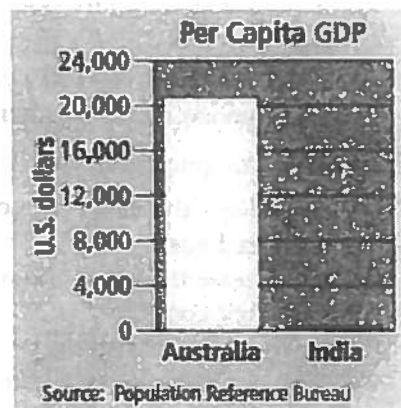
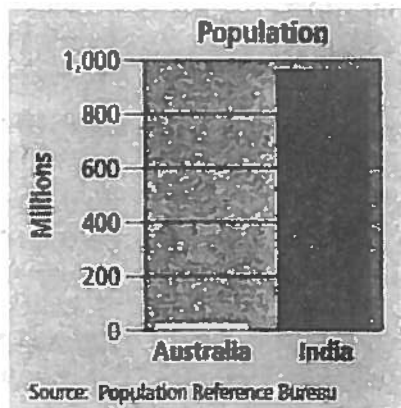
Other ways to measure development include the literacy, life expectancy, and infant mortality rates. The **literacy rate**, the proportion of people over age 15 that can read and write, is higher in developed countries. So is **life expectancy**, the average expected life span of an individual. The **infant mortality rate**, the number of deaths that occur in the first year of life per 1,000 births, is lower in developed countries.

THE BIG IDEA

The world's nations experience different levels of economic development.

GRAPHIC SUMMARY: Comparing Two Countries

Nations with the lowest per capita GDP are the nations with the lowest level of development.



REVIEW QUESTIONS

1. What is measured by per capita GDP?
2. **Graph Skills** Which country has the larger population? Which country has the larger per capita GDP?

SECTION 2

ISSUES IN DEVELOPMENT

TEXT SUMMARY

Rapid population growth is a serious problem in many less developed countries. The **population growth rate**, the increase of a country's population in a year, including births, deaths, and migrations, averages about 1.7 percent in LDCs. In developed nations, the rate is about 0.5 percent. Many LDCs are experiencing an increase in life expectancy, and birth rates far outpace deaths. This leads to rapid population growth. Increased populations require increased job opportunities, health and education facilities, industrial and agricultural production, and exports and imports.

The uneven distribution of natural resources throughout the world also affects development. Only 10 percent of Earth's land is **arable**, or suitable for growing crops.

LDCs often lack the physical and human capital necessary to develop resources. Without physical capital, human-made resources used to create goods and services, industry cannot grow

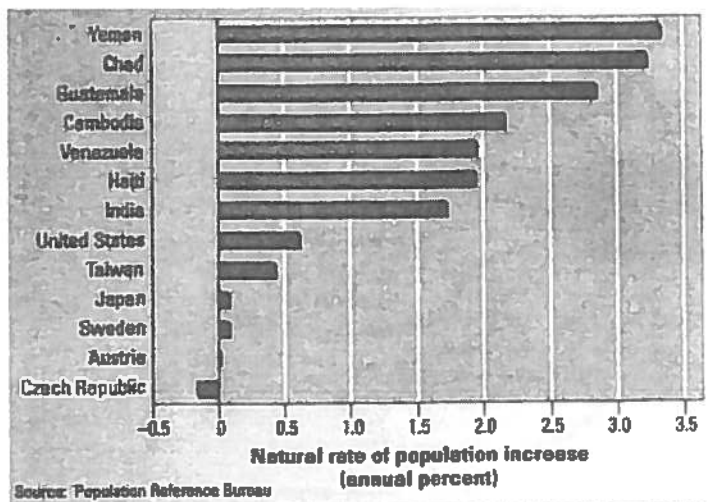
and agricultural output will remain low. Human capital, the skills and knowledge of workers, is critical to economic development. Access to education is limited, and literacy rates are low, especially for girls, who often have less opportunity than boys. When a country does not have sufficient human capital, it lacks the skilled workers necessary to manage industries. Foreign investors will be discouraged from investing in that country's businesses.

Other problems for LDCs are health and political issues. Many people in LDCs suffer from **malnutrition**, or inadequate nutrition. Political factors have limited the development of many poor nations. These include dependence on former colonial powers, experiments with central planning, and corrupt or unstable governments.

THE BIG IDEA

LDCs' problems include rapid population growth, limited natural resources, and lack of physical and human capital.

GRAPHIC SUMMARY: Population Growth Rates of Selected Nations



Nations with high population growth rates have difficulty providing goods and services to their rapidly growing populations.

REVIEW QUESTIONS

1. Why is a high population growth rate a problem for LDCs?

2. **Graph Skills** Which three of these nations are experiencing the most rapid population growth?

TEXT SUMMARY

A country can use two methods to finance its economic development. **Internal financing** comes from citizens' savings. In less developed countries (LDCs), however, citizens have little money to save. For that reason, most LDCs turn to **foreign investment**, external investment originating from other countries, to finance development. There are two types of foreign investment. **Foreign**

There may be military, political, and economic reasons for this foreign aid. For example, during the early 1940s the United States gave nearly \$50 billion in supplies to its allies in World War II.

International institutions also promote development. The **World Bank**, the largest provider of development assistance, offers loans, advice, and other resources to LDCs. The **United Nations Development Program (UNDP)** is dedicated to the elimination of poverty through development. The **International Monetary Fund (IMF)**, originally created to stabilize international exchange rates, has expanded its role to promote development. The IMF offers advice and technical assistance to LDCs. It can also help LDCs that are having trouble repaying a debt to a nation that lent it money. It does this by helping to arrange **debt rescheduling**, lengthening the time of repayment and forgiving or dismissing part of the loan.

THE BIG IDEA

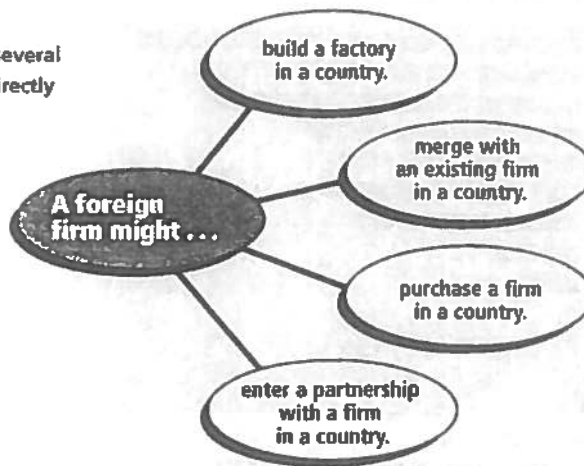
LDCs can obtain capital for development through investment, loans, and foreign aid.

direct investment (FDI) is the establishment of an enterprise by a foreigner. Much foreign direct investment comes from multinational corporations (MNCs), large corporations that produce and sell throughout the world. **Foreign portfolio investment** occurs when foreigners buy in a country's stock and bond markets, often by purchasing shares in mutual funds.

Foreign governments may give money to LDCs for development or disaster relief.

GRAPHIC SUMMARY: Foreign Direct Investment

Foreign firms have several ways of investing directly in other countries.



REVIEW QUESTIONS

1. What are three international institutions that promote development?
2. **Diagram Skills** What are four means of foreign direct investment?

TRANSITIONS TO FREE ENTERPRISE

TEXT SUMMARY

Many LDCs are attempting the difficult transition from centrally planned economies to free markets. One step in this transition is **privatization**, the sale or transfer of state-owned businesses to individuals. Another step is to change the legal system to guarantee and protect private property rights. Inefficient businesses may fail in a competitive system, leading to rising unemployment and unrest. Workers who never had incentives to work hard must learn a new **work ethic**, a system of values that gives central importance to work.

Russia is an example of a country that completely threw out its centrally planned economy and replaced it with one based on free markets. Until the late 1980s, Russia was part of the communist Soviet Union. But communism and the Soviet Union itself collapsed in 1991. Russians experienced hardships as they moved quickly to a market-based economy.

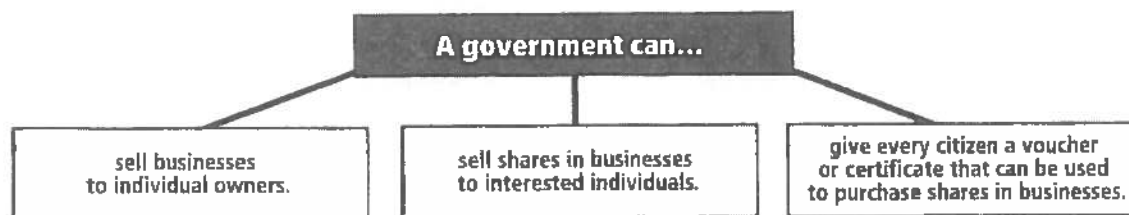
Without price controls, prices of many goods tripled. Billions of dollars flooded the country from the IMF and other institutions, but because of mismanagement and corruption, the funds were not used efficiently.

China is a communist country that is attempting to modify its centrally planned economy with some free market practices. The government has contracts with farmers to grow a certain amount of crops, letting them profit from any extra crops they are able to grow. With an incentive to grow more, farmers increased production. China also set up **special economic zones**, designated regions where foreign investment is encouraged. Since the start of these reforms, China's economy has quadrupled in size.

THE BIG IDEA

A nation's government and people face large challenges when shifting from a command economy to a market economy.

GRAPHIC SUMMARY: Privatizing State-Owned Businesses



A government has several options in privatizing its state-owned businesses.

REVIEW QUESTIONS

1. What is privatization?
2. **Diagram Skills** What are three ways a government can privatize its state-owned businesses?

CHAPTER 18 *Test***IDENTIFYING MAIN IDEAS**

Write the letter of the correct answer in the blank provided. (10 points each)

- _____ 1. The primary measure of a nation's level of development is its
- A. population.
 - B. industrialization.
 - C. gross domestic product.
 - D. per capita gross domestic product.
- _____ 2. The literacy rate is
- A. how fast people can read.
 - B. the proportion of a country's people that can read and write.
 - C. the number of languages people in a country can speak.
 - D. the percentage of people who have finished high school.
- _____ 3. One factor that is usually higher in less developed countries (LDCs) than in developed countries is
- A. per capita GDP.
 - B. level of material well being.
 - C. life expectancy.
 - D. infant mortality.
- _____ 4. Rapid population growth is occurring in many LDCs because
- A. life expectancy is increasing, and birth rates far outpace deaths.
 - B. governments encourage large families so that there will be more workers and consumers.
 - C. the food supply is increasing.
 - D. foreign investment is increasing.
- _____ 5. When a country does not have sufficient human capital
- A. malnutrition will decrease.
 - B. foreign investment will be discouraged.
 - C. literacy rates will climb.
 - D. its population will grow.
- _____ 6. Few LDCs can finance development with internal financing because
- A. there are no banks.
 - B. people prefer selling companies to other nations.
 - C. citizens have little money to save.
 - D. the World Bank does not permit internal financing.
- _____ 7. A great deal of foreign direct investment in LDCs comes from
- A. mutual funds.
 - B. other less developed countries.
 - C. multinational corporations.
 - D. local banks.
- _____ 8. The largest provider of development assistance to less developed countries is the
- A. World Bank.
 - B. United Nations Development Program
 - C. International Monetary Fund.
 - D. International Stock Exchange.
- _____ 9. Which of the following is NOT an important step in moving from a centrally planned economy to a market economy?
- A. revising the legal system
 - B. setting up price controls
 - C. privatization
 - D. changing the work ethic
- _____ 10. China's steps to modify its centrally planned economy included
- A. an emphasis on subsistence agriculture.
 - B. a loosening of political controls.
 - C. special economic zones to encourage foreign investment.
 - D. an increase in the military budget.