

Econ 2013 Study Guide For Exam 2

Chapter 6

- The size of government indicated by government expenditures as a percentage of U.S. GDP (1930: 9.4% of GDP, 2008: 35.3% of GDP)
- Federal government is spending taxpayer dollars on:
 1. Medicare and health
 2. Social security
 3. National defense
- Transfer payments – transfers of income from some individuals to others (social security, unemployment benefits, welfare, etc). Comprised of about 45% of total government spending
- Theories related to the economics of voting:
 1. Rational Ignorance Effect: a rational individual has little or no incentive to acquire information needed to cast an informed vote.
 2. Median voter theory: The idea that a vote maximizing politician in a two party system will be close to the middle so that there is little difference between candidates, and the preferences of the median voter will be represented.
- When the political process works well when voters pay in proportion to the benefits they receive, then productive projects will be passed and unproductive projects will not.
- User Charges – requires people who use a service more to pay a large share of the cost
- Ways in which the political process does not work well:
 1. Special interest effect: An issue that generates substantial benefits for a small group by generating minimal costs to a large group (Ex. Make me rich tax) Done through:
 - A. Logrolling: the practice of trading votes by a politician to get the necessary support to pass desired legislation
 - B. Pork-barrel Legislation : package of spending projects benefitting local areas financed through the federal government
 2. Shortsightedness Effect: politicians will favor programs that generate current visible benefits, even if long-term costs of the project outweighs the benefits.
 3. Rent seeking: Actions taken by individuals and groups in order to use the political process to take the wealth of others.
 4. Lack of profit motive: Unlike private firms, the public sector lacks the incentive to produce efficiently (Ex. Dentists giving leftover gold away so they can get at least the same amount next year)

Chapter 7

- Gross Domestic Product (GDP) – the market value of all final goods and services produced within a country during a specific period (usually a year)
- Understand what transactions get included into GDP and what transactions are left out.
- Know the two approaches for finding GDP:

1. Expenditure approach: Y (GDP) = C (Consumption) + I (Private Investment) + G (Government consumption and Gross Investment) + NX (Net Exports) Be able to calculate Investment (fixed investment + inventory investment), inventory investment (End investment – beginning investment), and Net Exports (Exports – Imports) so that you can calculate GDP
 2. Resource cost-income approach: Y = employee compensation + proprietor's income + rent + corporate profits + interest income + indirect business taxes + depreciation + Net income of foreigners.
- Gross National Product (GNP) – total market value of all final goods and services produced by the citizens of a country. Counts the income Americans earn abroad. Ignores the income foreigners earn in the U.S.
 - Nominal values – values expressed in current dollars
 - Real values – values that have been adjusted for the effects of inflation
 - Calculate Price Index: $P.I. = \text{cost of bundle in current year} / \text{cost of bundle in base year}$
 - Two most common price indexes:
 1. Consumer Price Index (CPI) – indicator of general levels of prices. Compares the cost of a typical market basket in a specific period to the cost of the same basket in a different period. Designed to measure the impact of price changes on the cost of the typical bundle of goods purchased by households.
 2. GDP Deflator – reveals the cost during the current period of purchasing the items included in GDP relative to the cost during the base year. Broader than CPI, includes capital goods and other goods purchased by businesses and government.
 - Limitations to using GDP as a measure of productivity
 1. Excludes non-market production (being a homemaker. Babysitter/gardener not included)
 2. Excludes the underground economy (waitress not recording tips)
 3. Excludes leisure and human costs (we get paid more for working less than in the past)
 4. Difficult measuring quality variation and introduction of new goods (high quality computer today for cheaper than the past)
 5. Excludes the costs of harmful side effects (more pollution there is, the less off we are, but does not get subtracted from GDP)
 - $\text{GDP per capita} = \text{GDP} / \text{Population}$
 - Per capita GDP is used as a broad indicator of general living standards.

Chapter 8

- Business cycles are fluctuations in the general level of economic activity. They are usually measured by 2 variables (changes in real GDP and unemployment rate)
- Business cycle definitions:
 - Expansion – characterized by growing GDP and declining unemployment
 - Peak – height of the expansion phase
 - Contraction – characterized by falling GDP and rising unemployment
 - Trough – the lowest point of the contraction phase
 - Recession – decline in real GDP for 2 or more consecutive quarters
 - Depression – a prolonged and severe recession

- Labor market definitions
 - Employed – if he/she has worked full or part time (even a few hours) in the past week or is on vacation or sick leave from a regular job
 - Unemployed – person who is not currently employed, but is actively seeking employment (in the last 4 weeks) and is waiting to start or return to a job
- Be able to calculate:
 1. Civilian Labor Force = Employed + Unemployed
 2. Labor Force Participation Rate = Civilian labor force / Population (age 16+)
 3. Unemployment Rate = Unemployed / Civilian labor force
 4. Employment or Population Ratio = Employed / Population (age 16+)
- 3 types of unemployment:
 1. Frictional Unemployment (U^f): Unemployment resulting from changes in the economy and imperfect information that prevents workers from being immediately matched up with existing job openings.
 2. Structural Unemployment (U^s): Unemployment due to structural characteristics of the economy that prevent the matching of available jobs with available workers.
 3. Cyclical Unemployment (U^c): Unemployment due to recessions and inadequate labor demand.
- Natural Unemployment (U^*) is the combination of Structural Unemployment and Frictional Unemployment and is not fixed but affected by the structure of the labor force and public policy.
- Actual Unemployment (U) is the sum all three types of unemployment and understand the relationship between Actual Unemployment and Natural Unemployment within the business cycles:
 1. Expansion: $U^* > U$
 2. Recession: $U^* < U$
 3. Full Employment: $U^* = U$
- Potential Output (Y^p): The level of output that can be achieved and sustained in the future, given:
 1. the size of the labor force
 2. expected productivity (quality of labor)
 3. natural rate of unemployment
 and know how it relates to business cycles:
 1. Expansion: Actual output (Y) > Potential output (Y^p)
 2. Recession: Actual output (Y) < Potential output (Y^p)
- Inflation – an increase in the general level of prices (% change in prices)
- Inflation = $\frac{\text{New Price Index} - \text{Old Price Index}}{\text{Old Price Index}}$
- Problems of high and variable inflation:
 1. Reduces investment
 2. Distorts the information delivered by prices
 3. Results in less productive use of resources
- Main sources of high inflation:
 1. Demand rising faster than supply
 2. Rapid increase in the money stock