

Penn State Department of Economics
ECON102 Practice Exam
Instructor: Dr. Dave Brown

Answer Key

Answers are highlighted in yellow.

This practice exam consists of short answer, graphing, fill-in-the-blank, and multiple choice questions. If you are able to answer all the questions in this format, you'll do very well on your exam.

1. In class, we discussed the minimum wage. Is the minimum wage a price floor or a price ceiling? Name one reason for and one reason against raising the minimum wage.

Minimum wage is a price floor. It is a legal minimum price of labor.

For: It may help a low-skill worker earn more money

Against: It may cause higher unemployment or cause a firm to cut jobs.

2. Our economy is "self-organized and decentralized". What does this mean? Who decides prices and quantities of goods? You may want to think about the main characteristics of market economies when answering this question.

The forces of supply and demand in a market determine the prices and quantities of goods.

In a decentralized economy, consumers and producers make their own decisions about buying and selling, rather than a command economy which is planned from the top down.

A market economy is "planned" from the bottom up.

3. Explain what it means for a good to be scarce.

There is not enough of the good to satisfy all wants at a price of zero.

4. Intuitively explain in one sentence what opportunity cost is.

Opportunity cost is the next best alternative. It's what we give up when we make a choice.

5. What is marginal decision making?

Marginal means additional. Making decisions at the margin means asking questions such as "what are the marginal costs and marginal benefits of one additional hour of studying?"

6. What does ceteris paribus mean?

Ceteris paribus is Latin for "all other things equal", or "everything else equal".

7. Are the following statements positive or normative? (fill in the blank)

Economics students perform better on the LSAT than any other major. Positive

Janitors do a lot of hard work and should get paid more. Normative

Students who graduate from Penn State make more money than Purdue graduates. Positive

Everyone should go to Penn State. Normative

Everyone should work in a bank to see the true value of money. Normative

8. What is an incentive? What is the purpose of an incentive? Given some examples of incentives.

An incentive is a reward or punishment for engaging in a certain behavior. The purpose of an incentive is to get an individual or a firm to behave in a way the incentive creator feels is more desirable.

Positive incentives: Money, candy, subsidies, extra credit, employee of the month award

Negative incentives: Jail, fines, fees, taxes, failing grade, getting fired from job

9. Define the following terms: rationality, self-interest.

Rationality: we will never intentionally do an action that will make us worse off

Self interest: when making a decision, we examine our own costs and benefits, and try to maximize our own well being. We do what's best for ourselves.

10. Give an example of a negative externality, and briefly explain it.

Smoking or pollution: An external cost is created that is borne by third parties.

Other examples: Noisy or messy roommate, flatulence... effects other people in a negative way.

11. Give an example of a positive externality, and briefly explain it.

Vaccines or education. For vaccines, if I stay healthy, you might stay healthy as well. This is an external benefit. Other examples: Wifi internet, raising hand during class and all students get an answer.

12. If supply and demand both increase simultaneously, what will the effect on P^* and Q^* be? You may want to draw a few graphs.

By itself, demand increasing will cause P^* to increase and cause Q^* to increase

By itself, supply increasing will cause P^* to decrease and cause Q^* to increase.

Thus, if these two shifts occur simultaneously:

Q^* will definitely increase

P^* could increase, decrease, or stay the same

13. Name two ways the government can correct a market failure in which a positive externality exists. Remember that with a positive externality, there are external benefits that we are not accounting for.

With a positive externality, there are benefits that are not being accounted for. Thus, we need to make people internalize the benefits. We need to increase the demand for the good. We can do this by subsidizing or rewarding people who consume the good, or require them to consume it.

14. Name 1 source of comparative advantage for the individual level *and* the national level.

Individual: inborn talent, education, training

National: resources, topography, climate, culture and laws