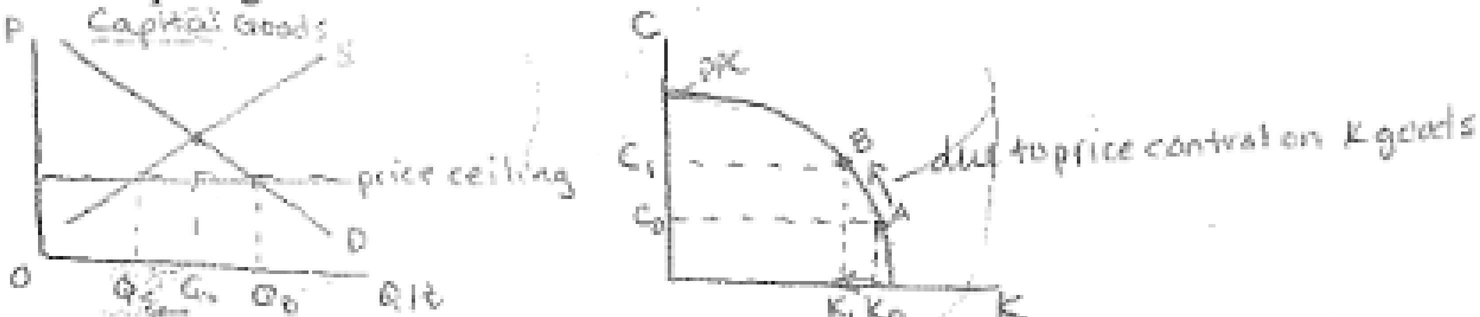
Exam 1 Sample Questions

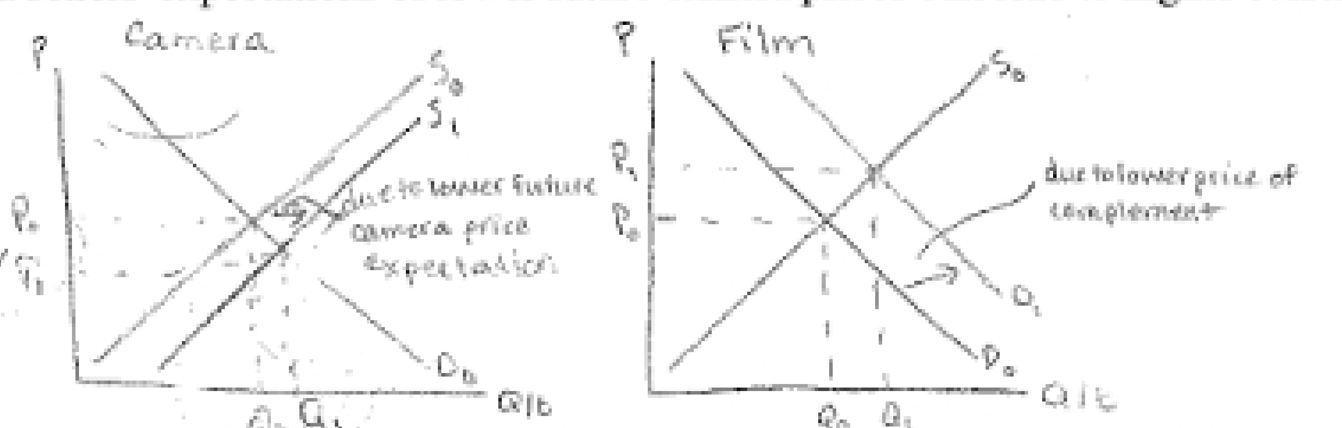
1. Suppose that the economy produces two types of goods: consumer goods (C) and capital goods (K). Use production possibilities curve (PPC) diagrams and brief verbal explanations to explain the following situations:

a. The economy is operating at full-employment producing a lot of capital goods when a legal price ceiling is imposed on capital goods.



b. The economy is operating at full-employment both before and after a major technological improvement in the production of consumer goods. After the technological improvement, however, the economy is actually producing *fewer* consumer goods than before.

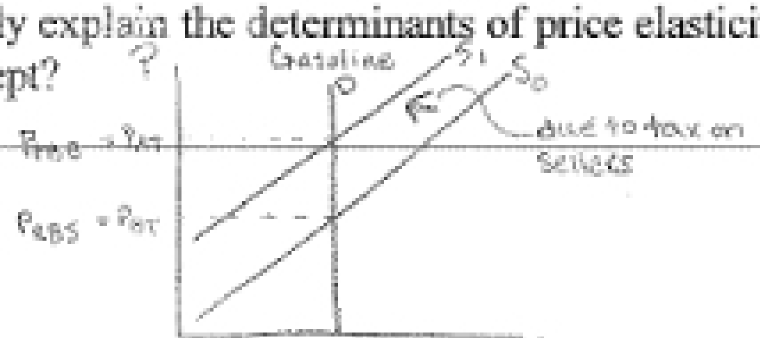
2. Use competitive market supply/demand diagrams of the camera market *and* the film market to illustrate how camera sellers' expectations of lower future camera prices can lead to higher current film prices.



P
Q
TR

3. Use a competitive market supply/demand diagram and brief verbal descriptions to explain how the entire economic incidence of a per-unit excise tax may fall on gasoline buyers even though the tax is legally imposed exclusively on gasoline sellers.

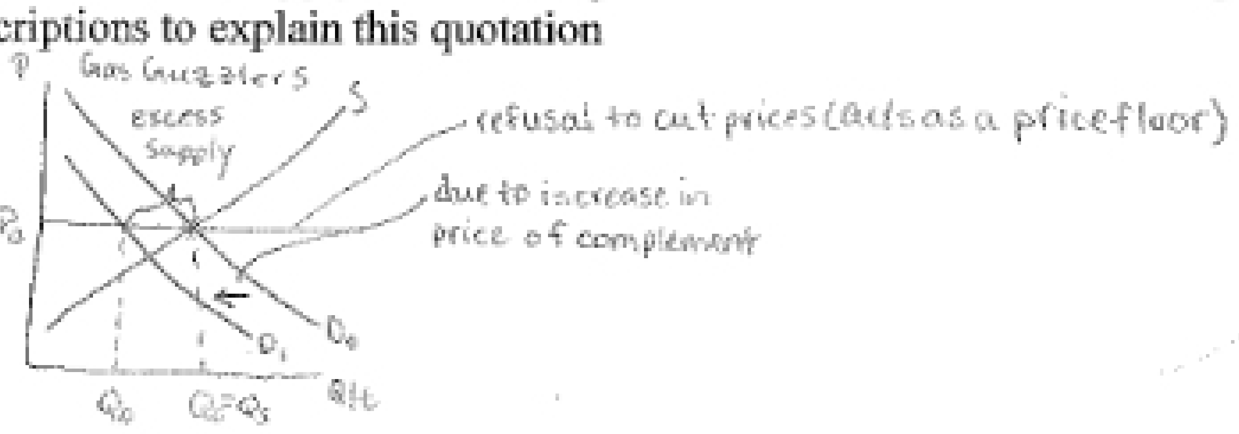
Briefly explain the determinants of price elasticity of demand (E_d). Why is price elasticity of demand an important concept?



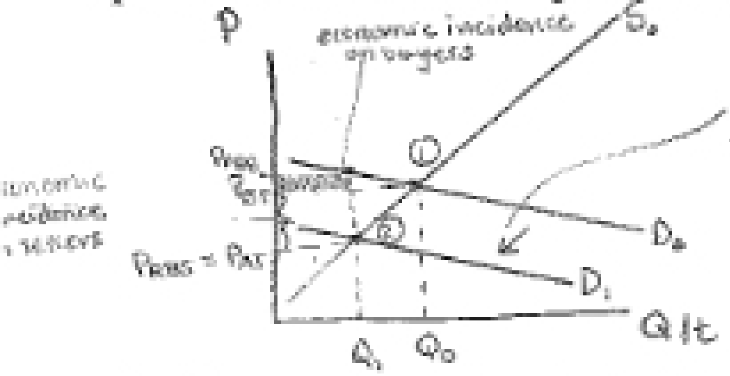
1 number of substitutes
2 fraction of income
3 time period (adjustment)
4 taste: necessities/luxuries

(see 22)

4. Consider the following: "The sharp rise in gasoline prices in the mid 1970's lead to a sharp decline in the demand for 'gas guzzling' cars and large unsold inventories (surpluses) when many dealers refused to cut their sticker prices." Use a supply/demand diagram of the 'fuel inefficient' or 'gas guzzling' car market and brief verbal descriptions to explain this quotation



5. In 1990, Congress passed a per-unit excise tax on yachts. The tax was legally imposed on the buyers of these luxury goods. Within a year, a number of New England yacht building firms failed and their unemployed workers protested vigorously. Interestingly, yacht buyers voiced little concern about the tax. Use a supply/demand diagram of the yacht market and your knowledge about the legal and economic incidence of a per-unit excise tax to explain this episode.



luxury good ⇒ more elastic demand ($\varepsilon_d > 1$)

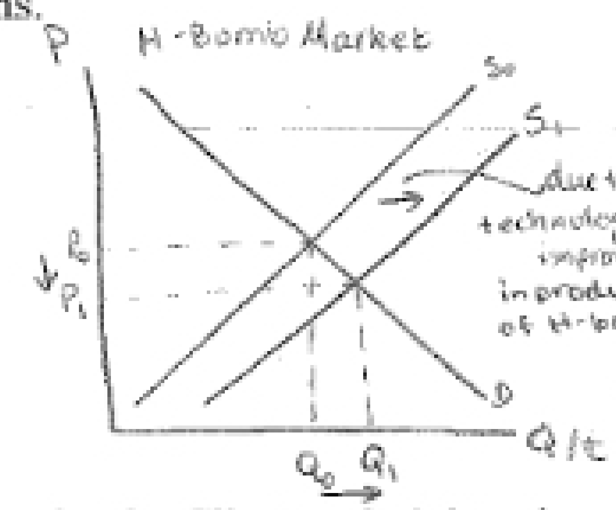
P_{PBB} = price paid by buyers after tax

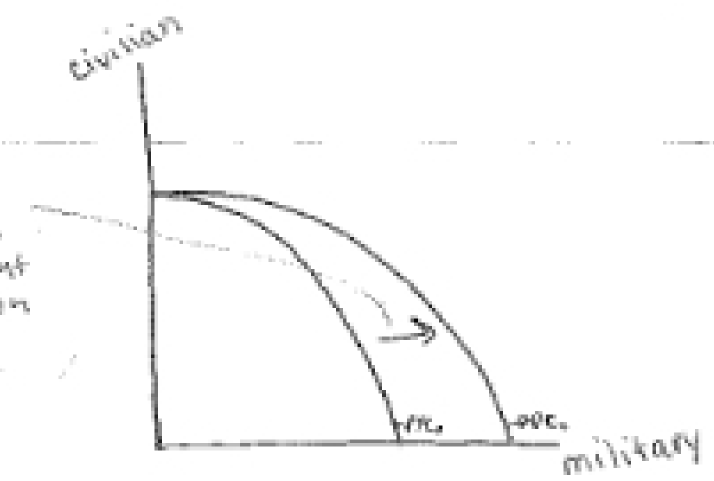
P_{RBS} = price received by sellers after tax

P_{BT} = price before tax

P_{AT} = price after tax

6. Suppose there is a technological advance in the production of hydrogen bombs. Use a supply/demand diagram of the hydrogen bomb market *and* a production possibilities curve (PPC) diagram showing 'military' and 'civilian' goods to illustrate this technological change. Carefully explain the connection between your diagrams.





7. Recently, the Clinton administration proposed a $1.00 per-unit (pack) excise tax on cigarettes (which would be imposed *legally or statutorily* on cigarette *sellers*). Some news reports have suggested that the proposed tax would increase cigarette prices by $1.00 per pack and be paid entirely by smokers (cigarette *buyers*). Using a competitive supply/demand diagram of the cigarette market, carefully *show* and *explain* the circumstances under which these new reports would be true.

$E_d = 0$ ⇒ demand is perfectly inelastic

8. Why are there so many different nominal interest rates? Explain carefully.

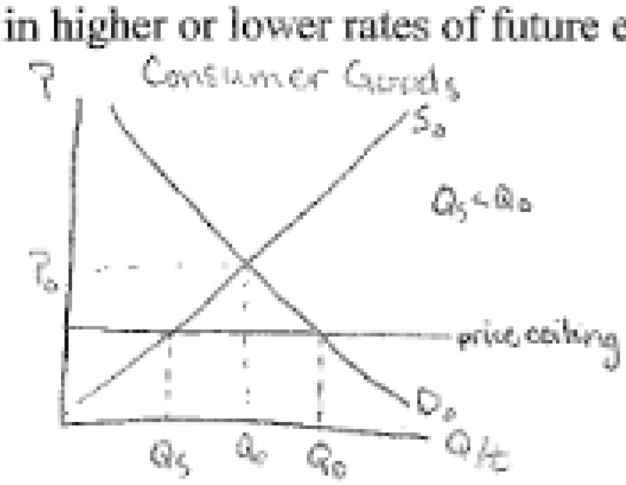
1) default risk – the risk that a lender might not be paid back
- US gov't bond is said to be default riskless
- junk bonds – high default risk, issued by corporations, presumably in iffy financial circumstances
- higher default risk ⇒ higher interest rate

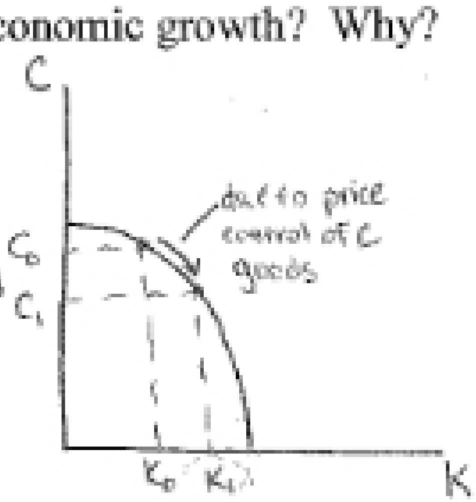
2) term to maturity – how long until a lender gets repaid
- short-term interest rates are lower (longer → higher)

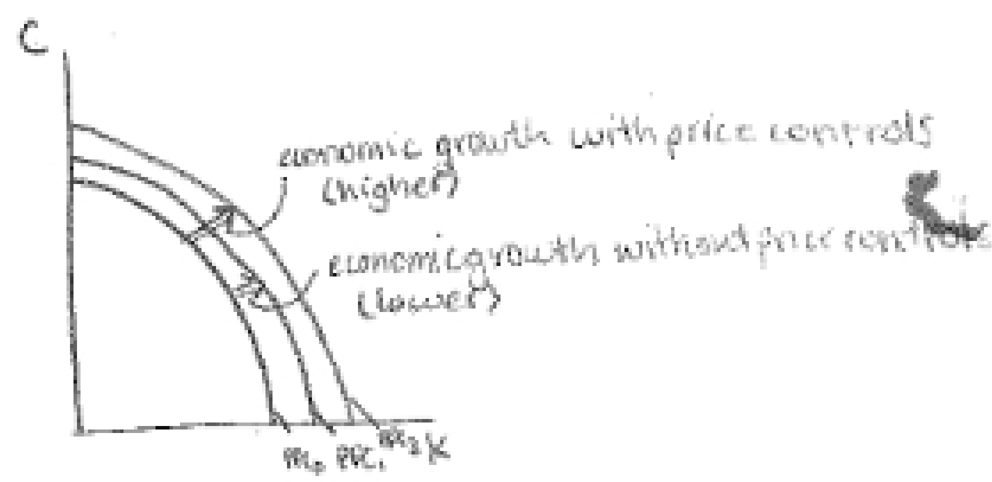
- lower interest rate on tax-free
- higher rates on taxed bonds

3) tax treatment – some bonds (municipal bonds) pay interest income that is not subject to income taxes, sometimes called tax-free or munis

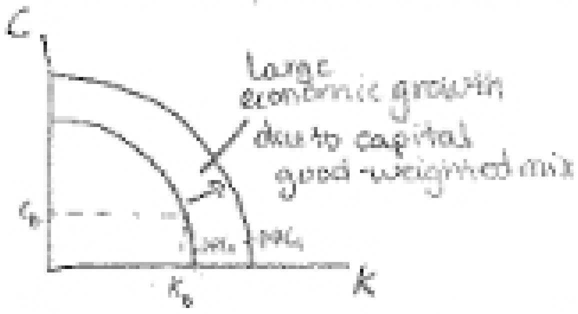
9. Consider an economy that produces consumer goods and capital goods. Suppose the economy is operating at full-employment and all consumer goods are subject to legal price ceilings set below equilibrium prices. Use a production possibilities curve (PPC) diagram and brief verbal descriptions to compare this economy's production combination in the absence of price controls (15 points). In this case, would the price controls result in higher or lower rates of future economic growth? Why?

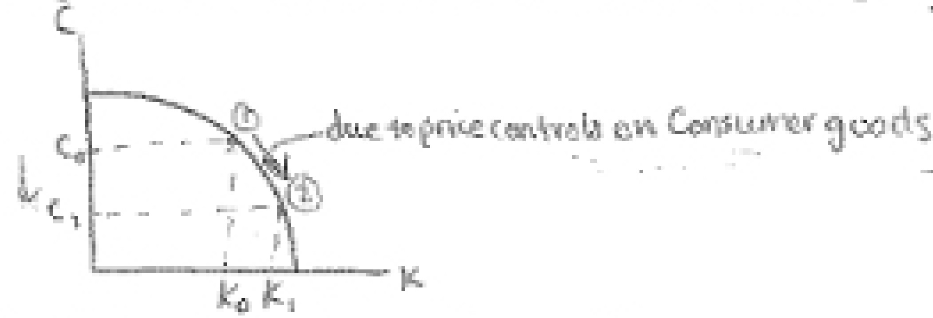


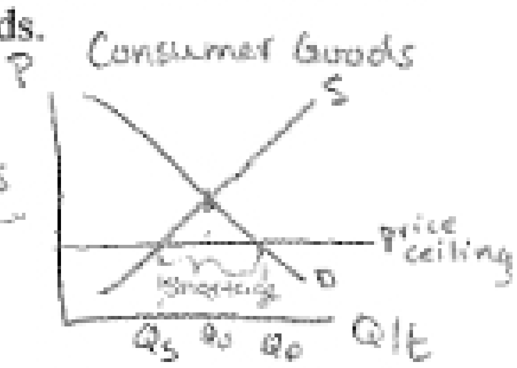




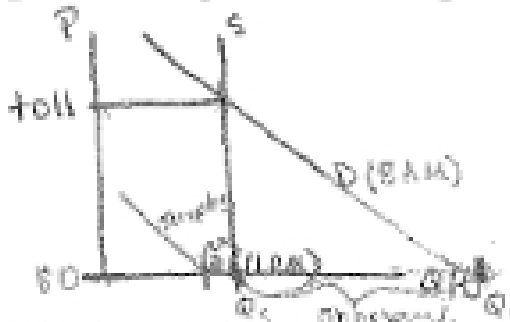
10. Consider the following: "Under the Five Year Plans, the Soviet leadership mandated a production mix heavily weighted toward capital goods. As a consequence, the Soviets enjoyed some years of significant economic growth. Coupled with price controls on consumer goods, however, the Plans also meant that Soviet citizens had very few consumer goods to satisfy their collective wants." Use a production possibilities curve (PPC) diagram and brief verbal descriptions to explain the Soviets' economic growth. Use another PPC diagram and brief verbal description to explain the small number of Soviet consumer goods.







11. Suppose the out-of-pocket price for driving on a freeway is zero. Now, use a competitive supply/demand diagram of the "freeway space" market to explain traffic jams at 8:00 am, but no jams at 11:00 pm. Also, use your diagram to explain the toll price that would eliminate the morning traffic jams.



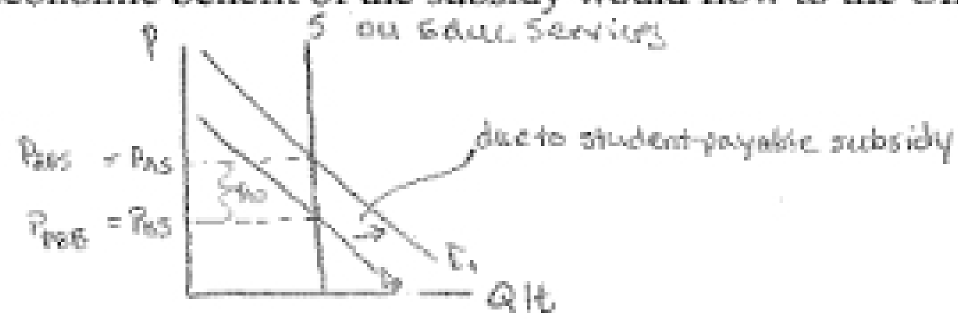
$E_s = 0$

⇒ Current price control at $0

⇒ implement price control at 'toll' line

$Q_D > Q_S$ ⇒ shortage

12. Suppose the State legislature passes a $10.00 per credit hour tuition <u>subsidy</u> legally payable to OU students. Use a supply/demand diagram of the OU educational services market to explain the conditions under which the entire economic benefit of the subsidy would flow to the University (not the students).



$E_s = 0$ (inelastic)

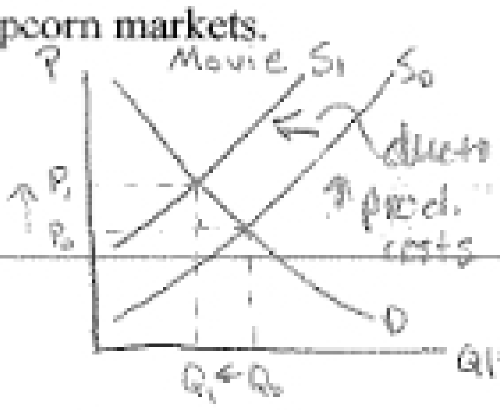
P_{AS} = price after subsidy

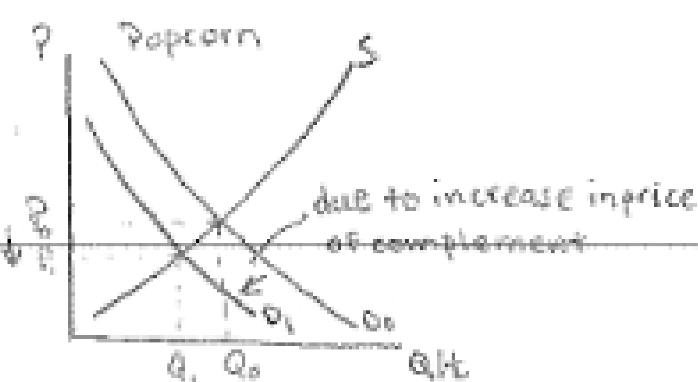
P_{BS} = price before subsidy

P_{RBS} = price received by sellers after subsidy (university)

P_{PBS} = price paid by buyers after subsidy (students)

13. Suppose that movies and popcorn are complimentary goods. Further suppose that screenwriters' wages (a major cost of producing movies) increase sharply due to a new union contract. Using *separate* competitive supply/demand diagrams of the movie *and* popcorn markets, illustrate and briefly explain the probable effects of the screenwriters' wage increase on: Equilibrium prices, equilibrium quantities, and total revenues in the movie and popcorn markets.





✱14. In 1992, Congress passed a per-unit excise tax on yachts. Although legally the tax was to be collected from <u>yacht suppliers</u>, the law was intended to make the rich yacht buyers pay more of the tax burden. The tax was repealed in 1993 in response to the vigorous protests of *yacht manufacturers and their workers*. Use a competitive supply/demand diagram of the yacht market and your knowledge of economic tax incidence to these events.