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Chapter 02

The Market System and the Circular Flow

Multiple Choice Questions

1. Which of the following is a distinguishing feature of a command system?

A. private ownership of all capital
B. central planning
C. heavy reliance on markets
D. widespread dispersion of economic power

2. Which of the following is a distinguishing feature of laissez-faire capitalism?

A. public ownership of all capital
B. central planning
C. minimal government intervention
D. a circular flow of goods, resources, and money

3. Examples of command economies are

A. the United States and Japan.
B. Sweden and Norway.
C. Mexico and Brazil.
D. Cuba and North Korea.

4. Of the following countries, which one best exhibits the characteristics of a market economy?

A. Canada
B. Cuba
C. North Korea
D. Belarus

5. The French term "laissez-faire" means

A. "there is no free lunch."
B. "let it be."
C. "circular flow."
D. "public ownership."

6. An economic system

A. requires a grouping of private markets linked to one another.
B. is a particular set of institutional arrangements and a coordinating mechanism used to respond to the economizing problem.
C. requires some sort of centralized authority (such as government) to coordinate economic activity.
D. is a plan or scheme that allows a firm to make money at some other firm's expense.

7. The term "laissez-faire" suggests that

A. land and other natural resources should be privately owned, but capital should be publicly owned.
B. land and other natural resources should be publicly owned, but capital should be privately owned.
C. government should not interfere with the operation of the economy.
D. government action is absolutely necessary if the economy is to achieve full employment and full production.

8. Economic systems differ according to which two main characteristics?

A. who owns the factors of production and the methods used to coordinate economic activity
B. the technology used in production and the quantity and quality of natural resources
C. how goods are produced and who gets them
D. the political system in place and the degree of scarcity facing the economy

9. Command systems are also known as

A. market systems.
B. pure capitalism.
C. laissez-faire capitalism.
D. communism.

10. A fundamental difference between the command system and laissez-faire capitalism is that, in command systems,

A. the division of output is decided by central planning rather than by individuals operating freely through markets.
B. all economic decisions are made by the government, whereas there is no government in laissez-faire capitalism.
C. scarcity does not exist, whereas it does in laissez-faire capitalism.
D. money is not used, whereas it is in laissez-faire capitalism.

11. Which of the following is *not* a typical characteristic of a market system?

A. private property
B. freedom of enterprise
C. government ownership of most property resources
D. competition in product and resource markets

12. Which of the following is a fundamental characteristic of the market system?

A. property rights
B. central planning by government
C. unselfish behavior
D. government-set wages and prices

13. Property rights are important because they

A. ensure an equal distribution of income.
B. encourage cooperation by improving the chances of mutually agreeable transactions.
C. guarantee that any exchange will make all parties better off than prior to the exchange.
D. allow the government to control how resources are allocated.

14. Private property

A. discourages cooperation because people don't want to part with what they own.
B. discourages innovation, as people are often afraid to risk losing their own property.
C. encourages owners to maintain or improve their property so as to preserve or enhance value.
D. does everything indicated by the other answers.

15. Copyrights and trademarks are examples of

A. capital goods.
B. human capital.
C. property rights.
D. public goods.

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16. Freedom of enterprise

A. is a characteristic that is common to most economic systems.
B. in a market system means that entrepreneurs can obtain and use economic resources without any legal restraint.
C. allows businesses, within broad limits, to choose what goods to produce.
D. refers primarily to the right of consumers to purchase what they want.

17. The main mechanism that regulates the market system is

A. self-interest.
B. private property.
C. competition.
D. freedom of enterprise and choice.

18. Broadly defined, competition involves

A. private property and freedom of expression.
B. independently acting buyers and sellers and freedom to enter or leave markets.
C. increasing opportunity costs and diminishing marginal utility.
D. capital goods and division of labor.

19. Competition means that

A. sellers can manipulate market price by causing product scarcities.
B. there are independently acting buyers and sellers in each market.
C. a product can be purchased at a number of different prices.
D. there is more than one seller in a market.

20. The division of labor means that

A. labor markets are geographically segmented.
B. unskilled workers outnumber skilled workers.
C. workers specialize in various production tasks.
D. each worker performs a large number of tasks.

21. Specialization in production is important primarily because it

A. results in greater total output.
B. allows society to avoid the coincidence-of-wants problem.
C. allows society to trade by barter.
D. allows society to have fewer capital goods.

22. Specialization—the division of labor—enhances productivity and efficiency by

A. allowing workers to take advantage of existing differences in their abilities and skills.
B. avoiding the time loss involved in shifting from one production task to another.
C. allowing workers to develop skills by working on one, or a limited number, of tasks.
D. all of the means identified in the other answers.

23. Specialization in production is economically beneficial primarily because it

A. allows everyone to have a job that he or she likes.
B. permits the production of a larger output with fixed amounts of resources.
C. facilitates trade by bartering.
D. guarantees full employment. 24.

On the basis of the information, it can be said that

A. no coincidence of wants exists between any two states.
B. a coincidence of wants exists between Michigan and Washington.
C. a coincidence of wants exists between Texas and Washington.
D. a coincidence of wants exists between Michigan and Texas. 25.

On the basis of the information, and assuming trade occurs between the three states, we can expect

A. Washington to exchange apples with Texas and receive money in return.
B. Washington to exchange apples with Michigan and receive money in return.
C. Texas to exchange lettuce with Michigan and receive autos in return.
D. Texas to trade lettuce directly for Washington apples. 26.

Given the information, and assuming trade occurs between the three states, we can expect

A. that there is no means by which Michigan can obtain lettuce while specializing in the production of autos.
B. that money will not be needed to accomplish the desired exchanges.
C. money to flow counter-clockwise from Michigan to Texas to Washington.
D. money to flow clockwise from Michigan to Washington to Texas.

27. Barter

A. is the major means of exchange in centrally planned economies.
B. accounts for over 30 percent of the dollar volume of all exchange in the U.S. economy.
C. entails the exchange of goods for goods.
D. is used to circumvent the problem of a lack of coincidence of wants among potential buyers and sellers.

28. The "coincidence of wants" problem associated with barter refers to the fact that

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A. for exchange to occur, each seller must have a product that some buyer wants.
B. money must be used as a medium of exchange or trade will never occur.
C. specialization is restricted by the size or scope of a market.
D. buyers in resource markets and sellers in product markets can never engage in exchange.

29. The use of money contributes to economic efficiency because

A. governmental direction of the production and distribution of output can be avoided by using money.
B. roundabout production could not occur without the availability of money.
C. it is necessary for the creation of capital goods.
D. it promotes specialization by overcoming the problems with barter.

30. The presence of market failures implies that

A. money is not an effective tool for exchange in a market system.
B. there is an active role for government, even in a market system.
C. individuals and firms should strive to be self-sufficient rather than specialize.
D. command systems are superior to market systems in the allocation of resources.

31. Which of the following characteristics is *least* unique to a market system?

A. private ownership of property resources
B. competition among buyers and sellers pursuing monetary returns
C. the widespread use of money
D. freedom of enterprise and choice

32. Which of the following is one of the Five Fundamental Questions?

A. Which products will be in scarce supply and which in excess supply?
B. Who should appoint the head of the central bank?
C. How much should society save?
D. What goods and services will be produced?

33. If competitive industry Z is making substantial economic profit, output will

A. fall in industry Z and firms will likely leave the market.
B. fall in all industries except industry Z.
C. expand in industry Z, as more resources will move to that industry.
D. expand in industry Z, but no new firms will enter the market.

34. From society's point of view, the economic function of profits and losses is to

A. promote the equal distribution of real assets and wealth.
B. achieve full employment and price level stability.
C. contribute to a more equal distribution of income.
D. reallocate resources from less-desired to more-desired uses.

35. In a market economy, a significant change in consumers' desire for product X will

A. alter the profits or losses received by suppliers of product X.
B. cause a reallocation of scarce resources.
C. cause some industries to expand and others to contract.
D. do all of the things mentioned in the other answers.

36. Economic profits in an industry suggest the industry

A. can earn more profits by increasing product price.
B. should be larger to better satisfy consumers' desire for the product.
C. has excess production capacity.
D. is the size that consumers want it to be.

37. Economic profits and losses

A. are both considered by economists to be a part of production costs.
B. are essential to the reallocation of resources from less desired to more desired goods.
C. have no influence on the composition of domestic output.
D. equalize the distribution of income in the long run.

38. If consumer desire for product X increases, all of the following will occur *except*

A. an increase in the profits of industry X.
B. an increase in the quantity of resources employed by industry X.
C. an increase in the output of industry X.
D. a decrease in the quantity of resources employed in industry X.

39. An increase in consumer desire for strawberries is most likely to

A. increase the number of strawberry pickers needed by farmers.
B. reduce the supply of strawberries.
C. reduce the number of people willing to pick strawberries.
D. reduce the need for strawberry pickers.

40. If competitive industry Y is incurring substantial losses, output will

A. expand as resources move toward industry Y.
B. contract as resources move toward industry Y.
C. contract as resources move away from industry Y.
D. expand as resources move away from industry Y.

41. The economic function of profits and losses is to

A. bring about a more equal distribution of income.
B. signal that resources should be reallocated.
C. eliminate small firms and reduce competition.
D. tell government which industries need to be subsidized.

42. If a competitive industry is neither expanding nor contracting, we would expect

A. total revenue to be zero.
B. economic profits to be zero.
C. total opportunity cost to be zero.
D. more resources to flow to that industry.

43. The competitive market system

A. encourages innovation because government provides tax breaks and subsidies to those who develop new products or new productive techniques.
B. discourages innovation because it is difficult to acquire additional capital in the form of new machinery and equipment.
C. discourages innovation because firms want to get all the profits possible from existing machinery and equipment.
D. encourages innovation because successful innovators are rewarded with economic profits.

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44. In a market economy, the distribution of output will be determined primarily by

A. consumer needs and preferences.
B. the quantities and prices of the resources that households supply.
C. government regulations that provide a minimum income for all.
D. a social consensus as to which distribution of income is most equitable.

45. The most efficient combination of resources in producing a given output is the combination that

A. comes closest to using the same quantities of land, labor, capital, and entrepreneurial ability.
B. minimizes the cost per unit of output.
C. uses the smallest total quantity of all resources.
D. conserves most on the use of labor.

46. Firms are motivated to minimize production costs because

A. it is the most environmentally friendly way to produce goods.
B. least-cost production techniques use the smallest total quantity of resources.
C. competitive pressures in the market will drive out higher-cost producers.
D. the government provides tax credits and subsidies to low-cost producers.

47.

Answer the question using the following data, which show all available techniques for producing 20 units of a particular commodity

Resource	Resource prices	Possible production Techniques				
		#1	#2	#3	#4	#5
Land	$4	2	4	2	4	4
Labor	3	1	2	4	1	3
Capital	3	5	2	3	1	2
Entrepreneurial Ability	2	3	1	1	4	1

In view of the indicated resource prices, the economically most efficient production technique(s) is (are) technique(s)

A. 1.
B. 2 and 4.
C. 3.
D. 1 and 3.

48.

Answer:the question using the following data, which show all available techniques for producing 20 units of a particular commodity

Resource	Resource prices	Possible production Techniques				
		#1	#2	#3	#4	#5
Land	$4	2	4	2	4	4
Labor	3	1	2	4	1	3
Capital	3	5	2	3	1	2
Entrepreneurial Ability	2	3	1	1	4	1

Assuming that the firm is motivated by self-interest and that the 20 units that can be produced with each technique can be sold for $2 per unit, the firm will

A. realize an economic profit of $10.
B. realize an economic profit of $4.
C. not earn any economic profit.
D. shut down rather than incur a loss by producing.

49.

Answer the question using the following data, which show all available techniques for producing 20 units of a particular commodity

Resource	Resource prices	Possible production Techniques				
		#1	#2	#3	#4	#5
Land	$4	2	4	2	4	4
Labor	3	1	2	4	1	3
Capital	3	5	2	3	1	2
Entrepreneurial Ability	2	3	1	1	4	1

If a new production technique is developed that enables a firm to produce 20 units of output with 3 units of land, 3 of labor, 1 of capital, and 2 of entrepreneurial ability, this technique would

A. not be adopted because, although it reduces production costs, it does not increase profit.
B. be adopted because it would lower production costs and increase economic profit.
C. not be adopted because it entails higher production costs than other available techniques.
D. be adopted, even though economic profits would be reduced slightly.

50.

Answer the question on the basis of the following information: Suppose 30 units of product A can be produced by employing just labor and capital in the four ways shown below. Assume the prices of labor and capital are $2 and $3, respectively.

	Production Techniques:			
	I	II	III	IV
Labor	4	3	2	5
Capital	2	3	5	1

Which technique is economically most efficient in producing A?

A. I
B. II
C. III
D. IV

51.

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Answer the question on the basis of the following information: Suppose 30 units of product A can be produced by employing just labor and capital in the four ways shown below. Assume the prices of labor and capital are $2 and $3, respectively.

	Production Techniques:			
	I	II	III	IV
Labor	4	3	2	5
Capital	2	3	5	1

If the price of product A is $0.50, the firm will realize

A. an economic profit of $4.
B. an economic profit of $2.
C. an economic profit of $6.
D. a loss of $3.

52. In a competitive market economy, firms select the least-cost production technique because

A. such choices will result in full employment of available resources.
B. to do so will maximize the firms' profits.
C. this will prevent new firms from entering the industry.
D. "dollar voting" by consumers mandates such a choice.

53. The market system's answer to the fundamental question "What will be produced?" is essentially

A. "Goods and services that are profitable."
B. "Low-cost goods and services."
C. "Goods and services that can be produced using large amounts of capital."
D. "Goods and services that possess lasting value."

54. The market system's answer to the fundamental question "How will the goods and services be produced?" is essentially

A. "With as much machinery as possible."
B. "Using the latest technology."
C. "By exploiting labor."
D. "In ways that minimize the cost per unit of output."

55. The market system's answer to the fundamental question "Who will get the goods and services?" is essentially

A. "Those most willing and able to pay for them."
B. "Those who physically produced them."
C. "Those who most need them."
D. "Those who get utility from them."

56. The market system's answer to the fundamental question "How will the system accommodate change?" is essentially

A. "Through government leadership and direction."
B. "Through the guiding function of prices and the incentive function of profits."
C. "Through training and retraining programs."
D. "Through trial and error."

57. The market system's answer to the fundamental question "How will the system promote progress?" is essentially

A. "Through government-funded research programs."
B. "Through redistribution of income to promote greater equality."
C. "Through training and retraining programs."
D. "Through the profit potential that encourages development of new technology."

58. The advent of Netflix movie streaming and Redbox kiosks renting DVD and Blu-ray movies have virtually demolished the market for video rentals from brick and mortar stores such as Blockbuster. This is an example of

A. creative destruction.
B. derived demand.
C. capital accumulation.
D. the difference between normal and economic profits.

59. "Consumer sovereignty" refers to the

A. fact that resource prices are higher than product prices in capitalistic economies.
B. idea that the pursuit of self-interest is in the public interest.
C. idea that the decisions of producers must ultimately conform to consumer demands.
D. fact that a federal agency exists to protect consumers from harmful and defective products.

60. The dollar votes of consumers ultimately determine the composition of output and the allocation of resources in a market economy. This statement best describes the concept of

A. derived demand.
B. consumer sovereignty.
C. the invisible hand.
D. market failure.

61. Which of the following is *not* one of the five fundamental questions?

A. What prices will be charged for goods and services?
B. Who will get the goods and services?
C. What goods and services will be produced?
D. How will the system promote progress?

62. "Consumer sovereignty" means that

A. buyers can dictate the prices at which goods and services will be offered.
B. advertising is ineffective because consumers already know what they want.
C. buyers control the quality of goods and services through regulatory agencies.
D. buyers determine what will be produced based on their "dollar votes" for the goods and services offered by sellers.

63. Which of the following best describes the invisible-hand concept?

A. The desires of resource suppliers and producers to further their own self-interest will automatically further the public interest.
B. The inability to substitute resources creates a conflict between private and public interests and calls for government intervention.
C. The market system is the best system for overcoming the scarce resources-unlimited wants problem.
D. Central direction by the government will improve resource allocation in a capitalistic economy.

64. The invisible hand refers to the

A. fact that the U.S. tax system redistributes income from rich to poor.
B. notion that, under competition, decisions motivated by self-interest promote the social interest.
C. tendency of monopolistic sellers to raise prices above competitive levels.
D. fact that government controls the functioning of the market system.

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65. The invisible hand concept suggests that

A. market failures imply the need for a national economic plan.
B. big businesses are inherently more efficient than small businesses.
C. the competitiveness of a capitalistic market economy invariably diminishes over time.
D. assuming competition, private and public interests will coincide.

66. Two major virtues of the market system are that it

A. allocates resources efficiently and allows economic freedom.
B. results in an equitable personal distribution of income and always maintains full employment.
C. results in price-level stability and a fair personal distribution of income.
D. eliminates discrimination and minimizes environmental pollution.

67. The market system

A. produces considerable inefficiency in the use of scarce resources.
B. effectively harnesses the incentives of workers and entrepreneurs.
C. is not consistent with freedom of choice in the long run.
D. has slowly lost ground to emerging command systems.

68. According to the concept of the "invisible hand," if Susie opens and operates a profitable childcare center, then

A. government should regulate the business to ensure quality.
B. the profit Susie earns indicates that she is overcharging for her services.
C. she has served society's interests by providing a desired good or service.
D. this demonstrates that consumer sovereignty is not present in this market.

69. The invisible hand promotes society's interests because

A. individuals pursuing their self-interest will try to produce goods and services that people in society want and are willing to purchase.
B. individuals will produce goods for others out of concern for their fellow human beings.
C. it makes sure that everyone wins from competition in the market.
D. government regulation pushes business into producing the right mix of goods and services.

70. The coordination problem in the centrally planned economies refers to the idea that

A. planners had to direct required inputs to each enterprise.
B. the price level and the level of employment were inversely related.
C. the immediate effect of more investment was less consumption.
D. exports had to be equal to imports for a central plan to work.

71. "Under central planning, some group has to decide how to get the necessary inputs produced in the right amounts and delivered to the right places at the right time. This is a nearly impossible task without markets and profits." This quotation best identifies the

A. incentive problem under central planning.
B. coordination problem under central planning.
C. self-sufficiency dilemma under communism.
D. resource overcommitment problem under communism.

72. "Because the outputs of many industries are the inputs to other industries, the failure of any single industry to fulfil the output quantities specified in the central plan caused a chain reaction of adverse repercussions on production." This quotation best identifies the

A. incentive problem under central planning.
B. self-sufficiency dilemma under communism.
C. resource overcommitment problem under communism.
D. coordination problem under central planning.

73. The incentive problem under communist central planning refers to the idea that

A. planners had to direct required inputs to each enterprise.
B. workers, managers, and entrepreneurs could not personally gain by responding to shortages or surpluses or by introducing new and improved products.
C. the immediate effect of more investment was less consumption.
D. exports had to be equal to imports for a central plan to work.

74. Suppose that an individual sees a tremendous opportunity to produce and sell a new product but dismisses the idea because there is no way to exploit this opportunity for personal gain. This situation best identifies the

A. coordination problem under communist central planning.
B. self-sufficiency dilemma under communism.
C. asymmetric information problem under communism.
D. incentive problem under communist central planning.

75. Innovation lagged in the centrally planned economies because

A. there was too much domestic business competition.
B. there was too much competition from foreign firms.
C. enterprises resisted innovation in fear that their production targets would be raised.
D. exports had to equal imports for the plan to work.

76. The fact that the major indicator of enterprise success in the Soviet Union and pre-reform China was the quantity of output implied that

A. product quality was neglected.
B. production costs were minimized.
C. product mix met consumer needs.
D. technological advance was too rapid.

77. Enterprise managers and workers in the Soviet Union often resisted innovations in production methods because

A. production targets were often increased when innovation occurred.
B. there was a chronic shortage of computers.
C. workers could not be reallocated geographically.
D. innovations ordinarily increased dependence on world markets.

78. If products were in short or surplus supply in the Soviet Union,

A. price and profit signals eliminated those shortages and surpluses.
B. price and profit signals intensified those shortages and surpluses.
C. producers would not react because no price or profit signals occurred.
D. the planners would immediately adjust production to achieve equilibrium.

79. In what type of business do the owners bear no personal financial responsibility for the company's debts and obligations?

A. partnerships
B. corporations
C. sole proprietorships
D. in all of the businesses listed in the other answers

80. The simple circular flow model shows that

A. households are on the buying side of both product and resource markets.
B. businesses are on the selling side of both product and resource markets.
C. households are on the selling side of the resource market and on the buying side of the product market.

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D. businesses are on the buying side of the product market and on the selling side of the resource market.

81. The two basic markets shown by the simple circular flow model are

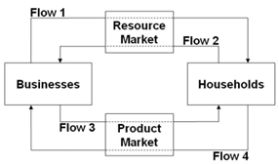
A. capital goods and consumer goods.
B. competitive and regulated.
C. product and resource.
D. household and business.

82. In the resource market,

A. businesses borrow financial capital from households.
B. businesses sell services to households.
C. households sell resources to businesses.
D. firms sell raw materials to households.

83. In the simple circular flow model,

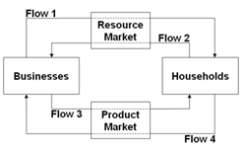
A. households are buyers of resources.
B. businesses are sellers of final products.
C. households are sellers of final products.
D. there are real flows of goods, services, and resources, but not money flows. 84.



Refer to the diagram. Flow 1 represents

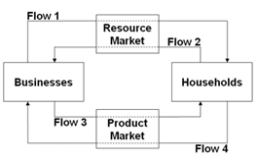
A. wage, rent, interest, and profit income.
B. land, labor, capital, and entrepreneurial ability.
C. goods and services.
D. consumer expenditures.

85.



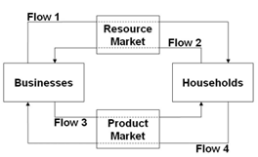
Refer to the diagram. Flow 2 represents

A. wage, rent, interest, and profit income.
B. land, labor, capital, and entrepreneurial ability.
C. goods and services.
D. consumer expenditures. 86.



Refer to the diagram. Flow 3 represents

A. wage, rent, interest, and profit income.
B. land, labor, capital, and entrepreneurial ability.
C. goods and services.
D. consumer expenditures. 87.



Refer to the diagram. Flow 4 represents

A. wage, rent, interest, and profit income.
B. land, labor, capital, and entrepreneurial ability.
C. goods and services.
D. consumer expenditures and business revenue.

88. In terms of the circular flow diagram, households make expenditures in the_____market and receive income through the_____market.

A. product; financial
B. resource;product
C. product;resource
D. capital; product

89. In terms of the circular flow diagram, businesses obtain revenue through the_____market and make expenditures in the_____market.

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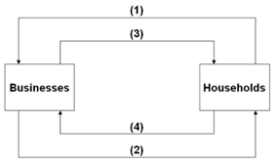
A. product; financial
B. resource; product
C. product; resource
D. capital; product

90. Households and businesses are

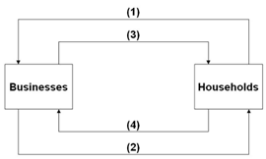
A. both buyers in the resource market.
B. both sellers in the product market.
C. sellers in the resource and product markets respectively.
D. sellers in the product and resource markets respectively. 91.



Refer to the diagram. Arrows (1) and (2) represent

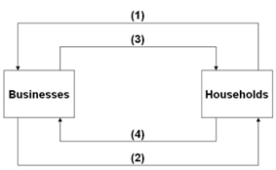
A. goods and resources, respectively.
B. money incomes and output, respectively.
C. output and money incomes, respectively.
D. resources and goods, respectively.

92.



Refer to the diagram. Arrows (3) and (4) represent

A. goods and services, respectively.
B. incomes and consumer expenditures, respectively.
C. resources and goods, respectively.
D. consumer expenditures and income, respectively. 93.



Refer to the diagram. Arrows (1) and (3) are associated with

A. the money market.
B. the resource market.
C. the product market.
D. international trade.

94. Which of the following best illustrates the circular flow model in action?

A. Bobbie goes to work and builds cars; she uses the income she receives to buy food at the grocery store.
B. Evan buys a new couch; the owner of the furniture store uses some of the money from the sale to pay her supplier and uses the rest to take her family out to dinner.
C. Boeing experiences a surge in orders for new airplanes, prompting the company to hire more workers.
D. All of these answers illustrate the workings of the circular flow model.

95. Risk is a problem faced

A. only in market systems.
B. only in command systems.
C. in both market systems and command systems.
D. in neither market systems nor command systems, only in laissez-faire capitalism.

96. Which of the following statements is true about risk management in market systems versus command systems?

A. Market systems manage risk better because entrepreneurs taking risks bear the costs of poor decisions, whereas in command systems government decision makers don't bear those costs.
B. Neither system is better than the other in terms of risk management; both systems are equally susceptible to natural disasters and changes in consumer preferences.
C. Command systems manage risk better because the government controls most economic activity and can therefore eliminate risk.
D. Market systems face risk because of the possibility of profits and losses; command systems don't face risk because they are not profit driven.

97. Risk management in command economies

A. is easy because there is no risk.
B. is easy because the government controls most activity and can eliminate risk.
C. tends to be done poorly because government officials do not understand risk.
D. tends to be done poorly because decision makers are insulated from the risk of making a poor decision.

98. In a market system,

A. firm owners and employees share business risk more or less equally.
B. a firm's employees and suppliers are largely shielded from risk, relative to business owners.
C. employees and suppliers face the greatest risks, because firms can shut down without notice and leave them unpaid.
D. a firm's owners are largely shielded from risk because they can walk away from the business at any time.

99. In a market system, employees and suppliers

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A. are usually shielded from risk, but at the cost of not sharing in the profits of the firm.
B. are usually shielded from risk and share in the profits of the firm.
C. are generally subject to as much risk as firm owners but get to share in the profits.
D. bear as much risk as firm owners but don't get to share in the profits.

100. A market system tends to restrict business risk to owners and investors. This results in which of the following benefits?

A. a more stable macroeconomy with fewer recessions
B. Firms are better able to attract inputs, as these inputs do not have to share the risk.
C. Government agencies are better prepared to help when businesses fail.
D. consistently lower prices for consumers

101. A market system tends to restrict business risk to owners and investors. This results in which of the following benefits?

A. It encourages more people to become entrepreneurs.
B. Firms have to pay more to attract inputs, as these inputs have to share the risk.
C. Firms focus attention on prudent risk management, as it is profitable to manage risk.
D. Income becomes more equally distributed.

102. (Consider This) In 1975, McDonald's introduced its Egg McMuffin breakfast sandwich, which remains popular and profitable today. This longevity illustrates the idea of

A. opportunity cost.
B. upsloping supply.
C. consumer sovereignty.
D. specialization.

103. (Consider This) In 2013, McDonald's introduced Fish McBites, which failed to catch on with the public and was subsequently dropped from the menu. This failure illustrates the idea of

A. consumer sovereignty.
B. technological change.
C. downsloping demand.
D. specialization.

104. (Consider This) Since World War II,

A. North Korea's command economy has significantly outperformed South Korea's market economy.
B. South Korea's command economy has significantly outperformed North Korea's market economy.
C. North Korea's market economy has significantly outperformed South Korea's command economy.
D. South Korea's market economy has significantly outperformed North Korea's command economy.

105. (Consider This) North Korea's command economy

A. is one of the few remaining command economies.
B. has grown much faster than South Korea's economy since the two countries were divided after World War II.
C. produces a per capita GDP of nearly $25,000.
D. has undergone significant market reforms and is now one of the fastest-growing economies.

106. (Consider This) Which of the following statements about insurance and risk is true?

A. Insurance inhibits economic growth and investment by discouraging risk-taking.
B. Insurance transfers risk from those with a high tolerance for risk to those with a low tolerance for risk.
C. Insurance companies always earn profits because insurance premiums always exceed the payout for insured events.
D. Insurance transfers risk from those with a low tolerance for risk to those with a higher tolerance for risk.

107. (Consider This) Martha's Milkshake Company buys earthquake insurance from the Stable Ground Insurance Company. Based on this purchase, economists would conclude that

A. Martha's believes a damaging earthquake is imminent.
B. Stable Ground believes no damaging earthquakes will occur.
C. Martha's has a lower tolerance for earthquake risk than Stable Ground.
D. Martha's has a greater tolerance for earthquake risk than Stable Ground.

108. (Last Word) According to economist Donald Boudreaux, the world's tens of billions of individual resources get arranged productively

A. because government has become highly effective at central planning.
B. because private property encourages people to consider the alternative uses of their resources and select those that provide the most rewards.
C. because people tend to be creative and orderly.
D. through random trial and error.

109. (Last Word) According to economist Donald Boudreaux,

A. private property eliminates the possibility that resource arrangements will be random.
B. the market system threatens to do irreparable harm to the world's ecosystem.
C. arranging resources under the market system is much like shuffling a deck of cards.
D. the market system works wondrously for advanced industrial nations but not for developing nations.

True / False Questions

110. Market economies use capital goods because they improve productive efficiency.

True False

111. Money functions as a medium of exchange by eliminating the need for a coincidence of wants.

True False

112. Consumer sovereignty means that legislation now protects the rights of consumers to dispose of their incomes as they see fit.

True False

113. Specialization may expand total output even though the individuals involved may have identical abilities.

True False

114. The wants of consumers are expressed in the product market with "dollar votes."

True False

115. Costs can be defined as total payments made to workers, landowners, and capital suppliers *less* payments to the entrepreneur for organizing and combining the other resources used to produce a good.

True False

116. Continued losses in an industry will cause some firms to reduce output or eventually leave the industry.

True False

117. The guiding function of prices tends to keep resources flowing toward their most highly valued uses.

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True False

118. The invisible hand refers to the many indirect controls that the federal government imposes in a market system.

True False

119. Central planning in the Soviet Union and pre-reform China emphasized expanding the production of consumer goods to raise the domestic standard of living.

True False

120. Central planning often suffers from a coordination problem and an incentive problem.

True False

Multiple Choice Questions

121. Economic systems differ from one another based on who owns the factors of production and

A. how many resources are available in the economy and where they are located.
B. how economic activities are coordinated and directed.
C. what kinds of products are produced in the economy and how they are sold.
D. how big the population is and the makeup of the population.

122. The market system is an economic system that

A. produces more consumer goods than capital goods.
B. produces more capital goods than consumer goods.
C. gives private individuals the right to own resources used in production.
D. emphasizes the government's power to control markets and direct economic activity.

123. The market system is also known as _, while the command system is also known as _.

A. capitalism; socialism
B. socialism; communism
C. central planning; laissez faire
D. a production system; a planning system

124. Laissez-faire capitalism limits the government's economic functions to the following, *except*

A. protecting private property rights.
B. establishing a legal environment to enforce contracts among individuals.
C. preventing individuals and firms from coercing others.
D. setting prices of individual goods and services.

125. One major element of the command system is

A. an emphasis on private ownership of resources.
B. individual decentralized decision making.
C. reliance on supply-and-demand forces to guide economic activity.
D. central planning conducted by the government.

126. The government may impose industrial safety regulations and occupational licensing requirements in which of the following economic systems?

A. laissez-faire economy
B. pure capitalism
C. mixed-market economy
D. macroeconomic system

127. In a command system,

A. self-interest motivates and commands each business firm's decisions and actions.
B. the head of each family decides and commands what to do with the family's resources.
C. a government-appointed planning board makes production and allocation decisions.
D. market traders command what outputs are produced and how they are allocated.

128. Which of the following would *not* be emphasized in a capitalist economy?

A. private ownership of capital and other resources
B. competition and decentralized decisions regarding production and consumption
C. reliance on market forces to coordinate economic activity
D. prevention of firms from exposing themselves to financial risk

129. The government may not implement policies intended to redistribute income in which of the following economic systems?

A. laissez-faire capitalism
B. command system
C. mixed economy
D. market system

130. The economies of North Korea and Cuba are

A. similar in that they are both basically command systems.
B. similar in that they are both basically market systems.
C. different in that North Korea has a command system, while Cuba has a market system.
D. different in that Cuba has a command system, while North Korea has a market system.

131. *Laissez-faire* capitalism is characterized by

A. very limited government role in the economy.
B. active government intervention in the economy.
C. individuals and firms abiding by a government economic plan.
D. the economic system of the United States today.

132. By freedom of enterprise, we mean that individual

A. workers are free to look for jobs and work in whichever firm will hire them.
B. firms are free to employ resources, to produce their output, and to sell their products.
C. producers are free to produce whatever the government decides is needed by the society.
D. consumers are free to buy whatever products will satisfy their needs the most.

133. Capitalism gets its name from the fact that capital resources are mostly

A. owned by the state or government.
B. given the highest priority in the economy's income distribution.
C. treated as private property.
D. in the form of money and financial resources.

134. The main characteristics of a modern market system include all of the following *except*

A. entrepreneurs are free to obtain and use resources to produce goods and services.

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B. consumers are free to buy goods and services that their budgets allow.
C. economic power is diffused by competition among economic units.
D. government is restricted to national defense and does not intervene at all in various markets.

135. In a market system, self-interest is the motivating force that

A. makes individuals unwilling to deliver anything of value to others.
B. makes owners of resources always want to use their resources themselves.
C. leads the economy to chaos and confusion, especially the larger economies.
D. coordinates and creates consistency in the operations of various parts of the economy.

136. Which of the following statements about self-interest in a market system is false?

A. Self-interest usually motivates an individual to deliver something of value to others.
B. Self-interest of entrepreneurs implies seeking maximum profits or minimum losses.
C. Self-interest applies only to capitalists and entrepreneurs, not to workers employed by others.
D. In a market system, consumers are just like firms: self-interest is what motivates them.

137. Consumers express self-interest when they

A. seek the lowest price for a product.
B. reduce business losses.
C. collect economic profits.
D. exclude others in their thinking.

138. Private property and freedom of choice in a market system have the following implications, *except*

A. individuals are free to take on the financial risks involved in a business.
B. trades that take place in the economy are mutually agreeable transactions among individuals.
C. economic agents are allowed to act in their own self-interest.
D. large firms are allowed to coerce other firms and individuals.

139. Which of the following statements about the right to private ownership is false?

A. It enables individuals to obtain, use, and dispose of land and capital resources as they see fit.
B. It encourages investment and innovation, and thus fosters economic growth.
C. It extends to intangibles such as pieces of music and computer programs.
D. It weakens the incentive to maintain the property that one already owns.

140. Competition is more likely to exist when

A. there is easy entry into and exit out of industries.
B. a government-issued license is required to set up a firm in an industry.
C. the government purchases most goods and services.
D. economic power is concentrated among a few large firms.

141. Competition in a market system denotes a condition where

A. the diffusion of economic power limits its potential abuse.
B. any given product can be purchased at a wide range of prices.
C. contractual agreements among individual firms are restricted and avoided.
D. a few large, dominant sellers are constantly jostling for market share.

142. Which of the following statements about markets and prices is correct?

A. In a market system, buyers and sellers must be in face-to-face contact with each other.
B. Prices affect the distribution of goods in a market system, but not the allocation of resources.
C. In a market system, prices serve to ration goods and services to consumers.
D. The operation of a market system has little, if any, effect on the distribution of income in the economy.

143. In a capitalist system, the decisions and actions of millions of consumers and firms are highly coordinated by

A. the state and government.
B. markets and prices.
C. a central planning agency.
D. an international organization.

144. All of the following statements describe a market economy *except*

A. government prescribes the market prices for goods and services.
B. prices provide important signals to buyers and sellers.
C. the allocation of resources is determined by their prices.
D. the actions of buyers and sellers establish a product's price.

145. A characteristic of the market system is

A. extensive use of direct or manual methods of production.
B. a focus on labor, as opposed to capital resources.
C. reliance on the use of capital goods in indirect modes of production.
D. avoidance of producing goods that do not satisfy consumer wants directly.

146. Which of the following does not foster innovation and technological advance?

A. competition in markets
B. freedom of choice and enterprise
C. self-interest and personal rewards
D. fear and avoidance of risk

147. The Heritage Foundation in 2015 ranked which of the following economies to have the highest economic freedom?

A. the United States
B. Germany
C. Japan
D. Hong Kong

148. A production system where various workers concentrate on different specialized tasks to contribute toward a whole product is referred to as

A. a coincidence of wants.
B. roundabout production.
C. freedom of enterprise
D. division of labor.

149. How does human specialization contribute toward increasing an economy's output?

A. It exploits the differences in abilities.
B. It is a process of creative destruction.
C. It pushes each worker to master the whole product.
D. It encourages people to be "jacks-of-all-trades."

150. With specialization in a market economy, individual

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A. firms produce a wide range of products.
B. producers consume little or none of the products they produce.
C. producers consume most of the output that they produce.
D. consumers have to produce most of what they consume.

151. Which of the following is *not* a reason why specialization and trade are beneficial to society?

A. The total output of economic goods may be increased even without any increase in resources.
B. Scarce resources are utilized more efficiently by exploiting differences among them.
C. Specialization fosters learning by doing, thus lowering the unit-costs of products.
D. Firms and workers become less dependent on others for producing goods and services.

152. A required element for specialization to lead to an increase in the satisfaction of society's wants is

A. a capitalist economy.
B. exchange and trade.
C. the use of money.
D. a central plan.

153. Specialization is beneficial

A. at the individual firm level, but not at the national and international levels.
B. at the individual, regional, and even international levels.
C. only if there are differences in the abilities of resources.
D. only as long as money and capital goods are employed.

154. Which is an example of barter?

A. a person trades a desk for a box of tools
B. a person buys clothes at a used clothing store
C. a gift of tuition money from parents to their children
D. the purchase of stock on the New York Stock Exchange

155. An economic system in which money is *not* used as a medium of exchange is a

A. planned economy.
B. market economy.
C. mixed economy.
D. barter economy.

156. Which of the following is necessary to make a trade in a barter economy?

A. money
B. unlimited wants
C. a medium of exchange
D. a coincidence of wants

157. The use of money for exchange and trade

A. increases the importance of barter.
B. fosters more specialization in production.
C. reduces consumer sovereignty.
D. raises the need for a coincidence of wants.

158. Anything that is generally acceptable in trading for goods and services is a

A. medium of exchange.
B. capital good.
C. store of value.
D. resource.

159. Which of the following is the main problem with the barter system of exchange?

A. It encourages self-interest.
B. It fosters the division of labor.
C. It requires a coincidence of wants.
D. It undermines the right to bequeath.

160. International specialization and trade

A. has to be done on a barter system.
B. often requires the exchange of currencies.
C. does not illustrate the division of labor.
D. requires active government regulation.

161. Why might a company use barter rather than money to make a trade?

A. Barter trade is generally more efficient than money-based trade.
B. Barter can enable two firms to trade when their cash flows are limited.
C. Money requires a coincidence of wants; barter is more direct.
D. Money is efficient only for large transactions, so barter is preferred for smaller transactions.

162. Which of the following is assumed to be most limited in scope under a market system?

A. entrepreneurship
B. self-interest
C. specialization
D. government

163. If a nation restricts trade with other nations, then the most likely effect is

A. lower prices of goods and services in the nation.
B. increased specialization of production.
C. expanded economic wealth of the nation.
D. consumers in the nation are made worse off.

164. Which is one of the five fundamental questions that need to be dealt with in any economic system?

A. What makes the rate of unemployment low?
B. Who will be the richest group in the economy?
C. How will goods and services be produced?
D. How high should the prices of goods and services be?

165. Which of the following is *not* one of the five fundamental questions that an economy must deal with?

A. How will the goods and services be produced?
B. Why should the goods and services be produced?
C. Who is to receive the goods and services produced in the economy?
D. In what ways will progress be promoted?

166. Consumer sovereignty and "dollar votes" guide the market system in dealing with which fundamental economic question?

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A. Which output will be produced?
B. How is the output to be produced?
C. How can the system accommodate change?
D. Who is to receive the output?

167. The term *consumer sovereignty* means that

A. government is responsible for protecting consumers' interests.
B. what is produced is ultimately determined by what consumers buy.
C. there are no limits on what consumers may buy in a market system.
D. producers have strong control over what consumers buy.

168. The market system is said to be characterized by "consumer sovereignty." This is because

A. a sovereign government determines which consumer goods will be produced.
B. the prices of consumer goods are regulated by a sovereign government.
C. firms must match their production decisions to the consumers' choices.
D. consumer goods are considered to be more important than capital goods.

169. The term *dollar votes* in a market system means

A. inflation will occur if consumers don't spend wisely.
B. voters may be offered dollars to help elect certain political candidates.
C. government is responsible for determining what will be considered legal tender.
D. consumers "vote" for certain products to be produced by how they spend their incomes.

170. In a market system, the "What will be produced?" question is ultimately decided by

A. profitability of products.
B. costs of production.
C. workers in the firms.
D. industry analysts.

171. Payments that a firm makes to obtain needed resources comprise its

A. costs.
B. profits.
C. capital.
D. revenues.

172. In a market system, more resources will move toward an industry and expand its production if the industry has

A. positive revenues.
B. positive costs.
C. TC < TR.
D. TC > TR.

173. In a market system, if firms in an industry persistently earn total revenues that are less than total costs, then that industry will

A. have some firms go out of business.
B. attract more resources toward it.
C. experience entry of new firms.
D. get government protection from failure.

174. In a market system, which of the following will eliminate high-cost producers and allow only the low-cost producers to survive?

A. competition
B. money
C. a sovereign government
D. specialization

175. If the total costs of producing 1,500 units of output is $15,000 and this output sold to consumers for a total of $16,500, then the firm would earn profits of A. $31,500.
B. $16,500. C. $1,500. D. $15,000.

176. The production technique that is most efficient is the one that produces a given amount of output

A. using the least amount of labor resources.
B. at the highest price per unit.
C. at the lowest cost per unit.
D. that yields the highest revenues.

177. McDonald's introduced the Big Mac in 1968, and it turned out to be a hit. However, the Arch Deluxe, introduced in 1996, was not. The success or failure of a product in the market system is determined by

A. capitalism and entrepreneurship.
B. specialization and exchange.
C. consumer sovereignty and dollar votes.
D. capital goods and roundabout production.

178. Economic efficiency is the primary guide in answering which of the fundamental questions in a market economy?

A. What will be produced?
B. How is the output to be produced?
C. How can the system accommodate change?
D. Who is to receive the output?

179.

Suppose a firm can produce 70 units of a product, Zenia, by combining labor, land, capital, and entrepreneurial ability, as in the four alternative techniques shown in the table below. Assume further that the firm can hire labor at $3 per unit, land at $3 per unit, capital at $6 per unit, and entrepreneurship at $9 per unit.

	Techniques			
	A	B	C	D
Labor	4	10	6	5
Land	5	3	3	3
Capital	5	2	4	4
Entrepreneurship	1	1	1	1

Refer to the provided table. Which technique is the most economically efficient way of producing Zenia?

A. A
B. B
C. C
D. D

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180.

Suppose a firm can produce 70 units of a product, Zenia, by combining labor, land, capital, and entrepreneurial ability, as in the four alternative techniques shown in the table below. Assume further that the firm can hire labor at $3 per unit, land at $3 per unit, capital at $6 per unit, and entrepreneurship at $9 per unit.

	Techniques			
	A	B	C	D
Labor	4	10	6	5
Land	5	3	3	3
Capital	5	2	4	4
Entrepreneurship	1	1	1	1

Refer to the provided table, and suppose that the firm uses production technique D. If each of the 70 units of Zenia that are produced sells for $1 apiece, then how much will be the total profits of the firm from 70 units of Zenia?

A. $70 B. $57 C. $13
D. $83

181.

Suppose a firm can produce 70 units of a product, Zenia, by combining labor, land, capital, and entrepreneurial ability, as in the four alternative techniques shown in the table below. Assume further that the firm can hire labor at $3 per unit, land at $3 per unit, capital at $6 per unit, and entrepreneurship at $9 per unit.

	Techniques			
	A	B	C	D
Labor	4	10	6	5
Land	5	3	3	3
Capital	5	2	4	4
Entrepreneurship	1	1	1	1

Refer to the provided table. If the price of labor declines from $3 to $2 per unit, then what is the least costly way of producing Zenias?

A. A
B. B
C. C
D. D

182.

The following table illustrates alternative production techniques for producing 18 widgets that can be sold for $1 each, for a total revenue of $18.

Resource	Price Per Unit of resource	Techniques (# of Units of Each resource Required)			
		A	B	C	D
Labor	$2	3	2	1	2
Land	1	2	1	3	1
Capital	4	1	2	2	3
Entrepreneurship	3	1	2	1	1

Based on the data given in the table, the most economically efficient production technique is

A. A.
B. B.
C. C.
D. D.

183.

The following table illustrates alternative production techniques for producing 18 widgets that can be sold for $1 each for a total revenue of $18.

Resource	Price Per Unit of resource	Techniques (# of Units of Each resource Required)			
		A	B	C	D
Labor	$2	3	2	1	2
Land	1	2	1	3	1
Capital	4	1	2	2	3
Entrepreneurship	3	1	2	1	1

Using technique A will result in an

A. economic loss of $2.
B. economic profit of $1.
C. economic profit of $2.
D. economic profit of $3.

184.

The following table illustrates alternative production techniques for producing 18 widgets that can be sold for $1 each for a total revenue of $18.

Resource	Price Per Unit of resource	Techniques (# of Units of Each resource Required)			
		A	B	C	D
Labor	$2	3	2	1	2
Land	1	2	1	3	1
Capital	4	1	2	2	3
Entrepreneurship	3	1	2	1	1

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If the price per unit of labor were to increase from $2 to $3, the most efficient production technique would then be

A. A.
B. B.
C. C.
D. D.

185. The following table illustrates alternative production techniques for producing 18 widgets that can be sold for $1 each for a total revenue of $18.

Resource	Price Per Unit of resource	Techniques (# of Units of Each resource Required)			
		A	B	C	D
Labor	$2	3	2	1	2
Land	1	2	1	3	1
Capital	4	1	2	2	3
Entrepreneurship	3	1	2	1	1

If the price of labor increases from $2 to $3, then the results of using Technique C will change from an economic

A. loss of $2 to a loss of $1.
B. profit of $2 to a profit of $1.
C. profit of $1 to a profit of $2.
D. loss of $1 to a loss of $2.

186. In a market system, the distribution of goods and services among consumers is largely determined by

A. the willingness and ability of consumers to pay the prices.
B. whoever needs the goods and services the most.
C. whoever has the closest connection to firms and the government.
D. a random factor that is almost impossible to predict.

187. "For whom is a given mix of goods and services to be produced? How, in other words, are the society's outputs to be distributed among its members?" In a market economy, this question is resolved primarily in the

A. public sector through the mechanism of central planning.
B. business sector through the mechanism of advertising.
C. private sector through the earning and spending of income.
D. money market through borrowing and saving by households and businesses.

188. The distribution of income in a market system is a primary factor that resolves which of the following fundamental economic questions?

A. What will be produced?
B. How will the output be produced?
C. How will the system accommodate change?
D. Who will get the output?

189. In a market economy, the incomes of consumers depend primarily upon

A. government policies in setting wages and interest rates.
B. the quantity and prices of resources that they possess.
C. the amount of savings that they have accumulated.
D. how closely connected they are to government and business leaders.

190. If economic profits in a particular industry increase, then we would expect

A. resources to be diverted away from that industry.
B. firms in that industry to produce less output.
C. firms to enter that industry, thus expanding it.
D. consumers to buy less from that industry.

191. In a market system, resources will move away from an industry when

A. profits of firms in the industry are rising.
B. demand for the industry's product is decreasing.
C. the production of output in the industry is rising.
D. profits of firms in other industries are falling.

192. "Creative destruction" in a market system is brought about by

A. entrepreneurship.
B. striking workers.
C. regulation by the government.
D. money-based trade.

193. An increase in the demand for a product and a reduction in its costs of production would

A. decrease the profits of producers.
B. encourage firms to leave an industry.
C. encourage firms to enter an industry.
D. cause a shortage of the product.

194. In a market system, as one industry expands while another contracts, resources will flow

A. away from the expanding industry toward the contracting one.
B. across industries, driven by the changes in resource prices paid by firms.
C. toward the industry where the product demand is declining.
D. because resource allocation will have to equalize between the two industries.

195. The market system communicates changes in market conditions and elicits appropriate responses from businesses and resource suppliers through changes in prices. This is known as the

A. guiding function of prices.
B. monetary function of prices.
C. circular flow of income.
D. market determination of prices.

196. The development of the digital video camera, which replaced film video cameras, is an example of

A. roundabout production.
B. derived demand.
C. creative destruction.
D. specialization.

197. Which of the following does *not* illustrate the idea of *creative destruction*?

A. Digital downloads have shrunk the market for CDs and DVDs.
B. Online retail sales have increased, while brick-and-mortar sales have slowed down.

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C. The opening of a new mall reduces the traffic in another mall.
D. A firm has to destroy some of the expired products in its inventory.

198. The idea that the desires of resource suppliers and firms to further their own self-interest will automatically further the public interest is known as

A. consumer sovereignty.
B. the invisible hand.
C. derived demand.
D. creative destruction.

199. Which of the following best describes the "invisible hand" concept?

A. Ample regulation of business by the government will maximize the public's best interests.
B. The market system works best when resources are free to move from one use to another.
C. The problem of scarcity can best be overcome in a system of mixed capitalism.
D. Self-interest in a market system will automatically promote the public interest as well.

200. The highly influential book by Adam Smith, who brought up the "invisible hand" notion, is titled

A. *Freakonomics.*
B. *The Principles of Economics.*
C. *The Age of the Economist.*
D. *The Wealth of Nations.*

201. The "invisible hand" concept refers to the

A. guiding function of prices in a market system.
B. implicit influence that the government has on the actions of firms.
C. regulatory structure that markets must operate in.
D. underlying money flows that promote the trading of goods and services.

202. Businesses seeking higher profits and resource suppliers seeking higher incomes lead to changes in the allocation of resources among different firms and end up with

A. consumers at the losing end.
B. output that society wants.
C. unnecessary conflict and turmoil.
D. a need for government action.

203. The major virtues of the market system include all of the following, *except*

A. it promotes an efficient allocation of resources.
B. it leads to equality in the distribution of income.
C. it provides incentives for greater production and higher incomes.
D. it emphasizes the freedom to pursue self-interest.

204. The market economy is regarded as "efficient" in that

A. it achieves the lowest rate of unemployment.
B. it leads to the lowest level of poverty in the society.
C. it directs resources toward products that the society wants most.
D. it puts the best people in government positions.

205. One basic problem faced by central planners, but hardly present in a market system, has to do with

A. determining the production goals or targets in a factory.
B. having limited resources and trying to match them with unlimited wants.
C. coordinating production in various industries so that bottlenecks do not develop.
D. providing financial resources for increasing the real flows of products in the economy.

206. The major "success indicator" for business managers in command economies like the Soviet Union and China *in the past* was

A. the quantity or volume of production.
B. product quality and variety.
C. the amount of profits a producer makes.
D. morale of workers in a firm.

207. A characteristic of centrally planned economies is that

A. the price is relatively unimportant in allocating resources.
B. profits are the main measure of success of a firm.
C. entrepreneurship is quite prevalent and highly rewarded.
D. there are many incentives for innovation and hard work.

208. Which of the following is true of an economy that operates entirely through central planning?

A. An individual's success in business is based on political savvy rather than economic profitability.
B. There is relative ease in matching resource allocation to consumer demand by the central planners.
C. Central planners receive market information and coordinate economic activity through the price mechanism.
D. The system adapts easily to technological change, because there is a healthy entrepreneurial spirit.

209. In a command economy like the old Soviet Union, one is able to improve one's lot and get ahead in society largely through

A. entrepreneurship and risk-taking.
B. innovation and profits.
C. participating in the political hierarchy.
D. getting high prices for one's products and resources.

210. According to economist Donald Boudreaux in the "Last Word" section of the chapter, what best explains why the market system is *not* a random, chaotic mess?

A. There is active cooperation among private property owners and government officials to correct the excesses of a market economy.
B. The roundabout methods of production allocate resources from consumers to producers in an orderly fashion.
C. Government planning limits the chaos, and the government regulates economic activity to create stability in the market.
D. Private property rights encourage mutual accommodation that leads to an arrangement of resources that is productive.

211. In the circular flow model of the market system, households' major role is to

A. buy both products and resources.
B. sell both products and resources.
C. buy products and sell resources.
D. sell products and buy resources.

212. In the circular flow model of the market system, business firms' major role is to

A. buy products and resources.
B. sell products and resources.
C. buy products and sell resources.
D. sell products and buy resources.

213. The circular flow model illustrates

A. the importance of having a central plan for the economy.

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B. how capital and other resources are created.
C. how money is created by the banking system.
D. the interdependence of businesses and consumers.

214. The simple circular flow model shows that workers and capital owners offer their services to firms through the

A. product markets.
B. resource markets.
C. money markets.
D. financial markets.

215. In the circular flow model, households earn their incomes in the

A. resource markets.
B. product markets.
C. capitalist markets.
D. money markets.

216. According to the circular flow model, product markets are where

A. households earn their money incomes.
B. households acquire economic resources from businesses.
C. businesses acquire their inputs from households.
D. businesses earn their revenues from households.

217. The money income of households consists of all the following, *except*

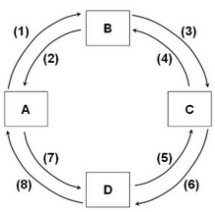
A. wages.
B. profits.
C. interest.
D. revenues.

218. Which of the following would be primarily determined in the resource markets?

A. the airfares charged by airlines for family vacations
B. the wage rates for computer programmers and engineers
C. the number of home-Internet connections installed
D. the amount of money in circulation issued by the government

219.

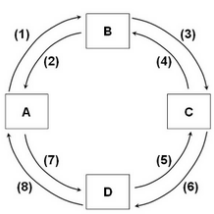
Refer to the provided figure. If box A represents households, B the product market, and C businesses, and if flow (3) represents revenues, then flow (1) would represent



A. costs.
B. money income.
C. consumption expenditures.
D. resources.

220.

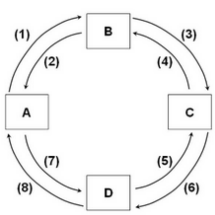
Refer to the provided figure. If box A represents households, D the resource market, and C businesses, then flow (8) would represent , while flow (7) would represent _.



A. goods and services; consumption expenditures
B. consumption expenditures; goods and services
C. resources; money income
D. money income; resources

221.

Refer to the provided figure. If box A represents households, B the product market, and C businesses, then flow (2) and flow (4) would represent



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A. the flow of labor and other resources.
B. the flow of goods and services.
C. business spending revenues
D. money incomes and consumer spending.

222. Which of the following is not a major category of business structure?

A. sole proprietorship
B. partnership
C. public agency
D. corporation

223. In the circular flow diagram, households get their ability to pay for their consumption expenditures from the

A. revenues they receive for their products.
B. costs they incur for resources.
C. incomes they earn for their resources.
D. goods and services they get in the product markets.

224. In the circular flow diagram, firms get their ability to pay for the costs of production from the

A. revenues they receive for their products.
B. resources they acquire in the resource markets.
C. incomes they earn for their resources.
D. goods and services they get in the product markets.

225. In a market system, the task of assessing and managing the business risk of a firm is taken on by the firm's

A. labor.
B. capital suppliers.
C. entrepreneurs.
D. customers.

226. Which of the following guides sensible decisions regarding the management of business risk in a market system?

A. the profit and loss system
B. the "invisible hand"
C. taxes and subsidies
D. consumer sovereignty

227. In a market system, a firm's employees are typically shielded from business risk by

A. profit-sharing agreements.
B. wage contracts.
C. the Social Security program.
D. paid vacation leaves.

228. One essential trade-off involving business risk in a market system is reflected in which of the following statements?

A. Access to the firm's profits and gains are open only to those who take on the business risk of the firm.
B. Those who receive guaranteed payments from the firm are also guaranteed a share of the firm's profits.
C. Those who make bad decisions regarding risk will suffer losses; those who decide wisely will gain profits.
D. Those who bear the business risk of the firm are guaranteed to always gain profits.

229. In a market system, which of the following is a major benefit of making the firm's owners and investors exclusively shoulder the business risk?

A. Those who deeply dislike business risk will not have anything to do with the business.
B. This allows firms to more easily attract labor and other suppliers of inputs.
C. This reduces the business risk in the economy.
D. It makes it easier for the government to monitor and manage the business risk.

230. Insurance companies facilitate the transfer of risk from

A. those who have a low-risk tolerance to those with high risk-tolerance.
B. those who have a high-risk tolerance to those with low risk-tolerance.
C. the insurance companies' owners to the insurance policyholders.
D. insurance policyholders to the government.

True / False Questions

231. A market system is characterized by the private ownership of resources and the use of prices to coordinate economic activity.

True False

232. Most market economies, such as the U.S. and the U.K., allow government policies and actions aimed at promoting economic growth and stability.

True False

233. In a command economy, the head of each household makes the fundamental economic choices such as what to produce and how to produce output.

True False

234. The economy of the United States in the past can best be described as *laissez-faire* capitalism.

True False

235. Property rights give to some people the right to coerce others into giving up their property.

True False

236. Property rights give the government the right to own, use, and dispose of resources in an economy.

True False

237. Selfishness and self-interest are identical concepts in economics.

True False

238. An important aspect of the market system is that producers and consumers always have to consider the public interest in making production and consumption decisions.

True False

239. If people tried to produce most of what they need on their own, then this would lead to a more efficient use of the economy's resources.

True False

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240. Being a "jack-of-all-trades" implies reducing the reliance on the division of labor.

True False

241. Even with the use of money, exchange and trade cannot occur if there is no coincidence of wants.

True False

242. One of the most important economic resources is money.

True False

243. In a market system, the distribution of goods and services largely depends on the distribution of income and people's preferences.

True False

244. The fundamental economic question regarding the distribution of output in the economy is equivalent to the question of who will produce the output.

True False

245. The concept of consumer sovereignty refers to the situation where consumers have the right to vote for the board of directors of large corporations.

True False

246. In analyzing a market system, economists often assume that firms will choose the production techniques that will give them the maximum revenues.

True False

247. Economic efficiency entails producing a certain output with the minimum number of units of inputs.

True False

248. The choice of the most efficient production technique is not affected by how much buyers want to buy the product.

True False

249. Even if prices are fixed and competition is restricted by the government, the invisible hand will still work in the economy and lead to economic efficiency.

True False

250. In a market system, a consumer's ability to pay—but *not* necessarily his willingness to pay—is largely based on his income.

True False

251. In a competitive market economy, firms and resource suppliers seeking to further their own self-interest will end up, as though guided by an invisible hand, promoting the public interest.

True False

252. The problems of central planning become less complex as an economy grows in size over time.

True False

253. Profits are the primary "success indicator" for firms in a centrally planned economy.

True False

254. Quantitative measures of managerial success, such as production targets or quotas, are highly foolproof and are thus ideal to use in raising economic efficiency.

True False

255. In the circular flow model, households act as buyers in the resource markets.

True False

256. In a market system, entrepreneurs start businesses in order to earn a high salary.

True False

257. In a market system, the income earned by owners of natural resources is called interest income.

True False

258. A corporation is a type of business firm where the debt of the firm is considered its owners' personal responsibility.

True False

259. According to the circular flow model of the market system, firms get their ability to pay for their costs of production from the revenues that they receive for their products.

True False

260. According to the circular flow model of the market system, when resource-owners' money income is rising, then the costs to business firms that employ their resources must be falling.

True False

261. Having a high fixed salary is what motivates entrepreneurs to make prudent decisions is dealing with business risk.

True False

262. Government bailouts of failing businesses, like banks during the recent economic crisis, will tend to reduce the motivation among entrepreneurs to make prudent decisions is dealing with business risk.

True False

263. College graduates who dislike business risk will mostly seek to be hired by firms as labor, rather than starting their own firms as entrepreneurs.

True False

264. When somebody buys an insurance policy, that person is seeking to transfer risk away from herself and pass it on to the insurance company.

True False

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Chapter 02 The Market System and the Circular Flow Answer Key

Multiple Choice Questions

1. Which of the following is a distinguishing feature of a command system?

A. private ownership of all capital
B. central planning
C. heavy reliance on markets
D. widespread dispersion of economic power

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Blooms: Analyze
Difficulty: 03 Hard
Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system.
Test Bank: 1
Topic: Economic Systems

2. Which of the following is a distinguishing feature of laissez-faire capitalism?

A. public ownership of all capital
B. central planning
C. minimal government intervention
D. a circular flow of goods, resources, and money

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Blooms: Analyze
Difficulty: 03 Hard
Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system.
Test Bank: 1
Topic: Economic Systems

3. Examples of command economies are

A. the United States and Japan.
B. Sweden and Norway.
C. Mexico and Brazil.
D. Cuba and North Korea.

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Difficulty: 03 Hard
Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system.
Test Bank: 1
Topic: Economic Systems

4. Of the following countries, which one best exhibits the characteristics of a market economy?

A. Canada
B. Cuba
C. North Korea
D. Belarus

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Difficulty: 03 Hard
Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system.
Test Bank: 1
Topic: Economic Systems

5. The French term "laissez-faire" means

A. "there is no free lunch."
B. "let it be."
C. "circular flow."
D. "public ownership."

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Difficulty: 03 Hard
Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system.
Test Bank: 1
Topic: Economic Systems

6. An economic system

A. requires a grouping of private markets linked to one another.
B. is a particular set of institutional arrangements and a coordinating mechanism used to respond to the economizing problem.
C. requires some sort of centralized authority (such as government) to coordinate economic activity.
D. is a plan or scheme that allows a firm to make money at some other firm's expense.

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Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system.
Test Bank: 1
Topic: Economic Systems

7. The term "laissez-faire" suggests that

A. land and other natural resources should be privately owned, but capital should be publicly owned.
B. land and other natural resources should be publicly owned, but capital should be privately owned.
C. government should not interfere with the operation of the economy.
D. government action is absolutely necessary if the economy is to achieve full employment and full production.

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Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system.
Test Bank: 1
Topic: Economic Systems

8. Economic systems differ according to which two main characteristics?

A. who owns the factors of production and the methods used to coordinate economic activity
B. the technology used in production and the quantity and quality of natural resources
C. how goods are produced and who gets them
D. the political system in place and the degree of scarcity facing the economy

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Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system.
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Topic: Economic Systems

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9. Command systems are also known as

A. market systems.
B. pure capitalism.
C. laissez-faire capitalism.
D. communism.

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Difficulty: 03 Hard
Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system.
Test Bank: 1
Topic: Economic Systems

10. A fundamental difference between the command system and laissez-faire capitalism is that, in command systems,

A. the division of output is decided by central planning rather than by individuals operating freely through markets.
B. all economic decisions are made by the government, whereas there is no government in laissez-faire capitalism.
C. scarcity does not exist, whereas it does in laissez-faire capitalism.
D. money is not used, whereas it is in laissez-faire capitalism.

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Difficulty: 03 Hard
Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system.
Test Bank: 1
Topic: Economic Systems

11. Which of the following is *not* a typical characteristic of a market system?

A. private property
B. freedom of enterprise
C. government ownership of most property resources
D. competition in product and resource markets

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Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: 1
Topic: Characteristics of the Market System

12. Which of the following is a fundamental characteristic of the market system?

A. property rights
B. central planning by government
C. unselfish behavior
D. government-set wages and prices

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: 1
Topic: Characteristics of the Market System

13. Property rights are important because they

A. ensure an equal distribution of income.
B. encourage cooperation by improving the chances of mutually agreeable transactions.
C. guarantee that any exchange will make all parties better off than prior to the exchange.
D. allow the government to control how resources are allocated.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: 1
Topic: Characteristics of the Market System

14. Private property

A. discourages cooperation because people don't want to part with what they own.
B. discourages innovation, as people are often afraid to risk losing their own property.
C. encourages owners to maintain or improve their property so as to preserve or enhance value.
D. does everything indicated by the other answers.

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Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: 1
Topic: Characteristics of the Market System

15. Copyrights and trademarks are examples of

A. capital goods.
B. human capital.
C. property rights.
D. public goods.

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Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: 1
Topic: Characteristics of the Market System

16. Freedom of enterprise

A. is a characteristic that is common to most economic systems.
B. in a market system means that entrepreneurs can obtain and use economic resources without any legal restraint.
C. allows businesses, within broad limits, to choose what goods to produce.
D. refers primarily to the right of consumers to purchase what they want.

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Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: 1
Topic: Characteristics of the Market System

17. The main mechanism that regulates the market system is

A. self-interest.
B. private property.

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C. competition.
D. freedom of enterprise and choice.

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Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: 1
Topic: Characteristics of the Market System

18. Broadly defined, competition involves

A. private property and freedom of expression.
B. independently acting buyers and sellers and freedom to enter or leave markets.
C. increasing opportunity costs and diminishing marginal utility.
D. capital goods and division of labor.

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Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: 1
Topic: Characteristics of the Market System

19. Competition means that

A. sellers can manipulate market price by causing product scarcities.
B. there are independently acting buyers and sellers in each market.
C. a product can be purchased at a number of different prices.
D. there is more than one seller in a market.

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Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: 1
Topic: Characteristics of the Market System

20. The division of labor means that

A. labor markets are geographically segmented.
B. unskilled workers outnumber skilled workers.
C. workers specialize in various production tasks.
D. each worker performs a large number of tasks.

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Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: 1
Topic: Characteristics of the Market System

21. Specialization in production is important primarily because it

A. results in greater total output.
B. allows society to avoid the coincidence-of-wants problem.
C. allows society to trade by barter.
D. allows society to have fewer capital goods.

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Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: 1
Topic: Characteristics of the Market System

22. Specialization—the division of labor—enhances productivity and efficiency by

A. allowing workers to take advantage of existing differences in their abilities and skills.
B. avoiding the time loss involved in shifting from one production task to another.
C. allowing workers to develop skills by working on one, or a limited number, of tasks.
D. all of the means identified in the other answers.

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Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: 1
Topic: Characteristics of the Market System

23. Specialization in production is economically beneficial primarily because it

A. allows everyone to have a job that he or she likes.
B. permits the production of a larger output with fixed amounts of resources.
C. facilitates trade by bartering.
D. guarantees full employment.

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Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: 1
Topic: Characteristics of the Market System

24.

On the basis of the information, it can be said that

A. no coincidence of wants exists between any two states.
B. a coincidence of wants exists between Michigan and Washington.
C. a coincidence of wants exists between Texas and Washington.
D. a coincidence of wants exists between Michigan and Texas.

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Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
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Topic: Characteristics of the Market System

25.

On the basis of the information, and assuming trade occurs between the three states, we can expect

A. Washington to exchange apples with Texas and receive money in return.
B. Washington to exchange apples with Michigan and receive money in return.
C. Texas to exchange lettuce with Michigan and receive autos in return.
D. Texas to trade lettuce directly for Washington apples.

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Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: 1
Topic: Characteristics of the Market System

26.

Given the information, and assuming trade occurs between the three states, we can expect

A. that there is no means by which Michigan can obtain lettuce while specializing in the production of autos.
B. that money will not be needed to accomplish the desired exchanges.
C. money to flow counter-clockwise from Michigan to Texas to Washington.
D. money to flow clockwise from Michigan to Washington to Texas.

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Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: 1
Topic: Characteristics of the Market System

27. Barter

A. is the major means of exchange in centrally planned economies.
B. accounts for over 30 percent of the dollar volume of all exchange in the U.S. economy.
C. entails the exchange of goods for goods.
D. is used to circumvent the problem of a lack of coincidence of wants among potential buyers and sellers.

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Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: 1
Topic: Characteristics of the Market System

28. The "coincidence of wants" problem associated with barter refers to the fact that

A. for exchange to occur, each seller must have a product that some buyer wants.
B. money must be used as a medium of exchange or trade will never occur.
C. specialization is restricted by the size or scope of a market.
D. buyers in resource markets and sellers in product markets can never engage in exchange.

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Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: 1
Topic: Characteristics of the Market System

29. The use of money contributes to economic efficiency because

A. governmental direction of the production and distribution of output can be avoided by using money.
B. roundabout production could not occur without the availability of money.
C. it is necessary for the creation of capital goods.
D. it promotes specialization by overcoming the problems with barter.

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Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: 1
Topic: Characteristics of the Market System

30. The presence of market failures implies that

A. money is not an effective tool for exchange in a market system.
B. there is an active role for government, even in a market system.
C. individuals and firms should strive to be self-sufficient rather than specialize.
D. command systems are superior to market systems in the allocation of resources.

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Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: 1
Topic: Characteristics of the Market System

31. Which of the following characteristics is *least* unique to a market system?

A. private ownership of property resources
B. competition among buyers and sellers pursuing monetary returns
C. the widespread use of money
D. freedom of enterprise and choice

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Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
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Topic: Characteristics of the Market System

32. Which of the following is one of the Five Fundamental Questions?

A. Which products will be in scarce supply and which in excess supply?
B. Who should appoint the head of the central bank?
C. How much should society save?
D. What goods and services will be produced?

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Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: 1
Topic: Five Fundamental Questions

33. If competitive industry Z is making substantial economic profit, output will

A. fall in industry Z and firms will likely leave the market.
B. fall in all industries except industry Z.
C. expand in industry Z, as more resources will move to that industry.
D. expand in industry Z, but no new firms will enter the market.

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Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress. Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: 1
Topic: Five Fundamental Questions
Topic: The Invisible Hand

34. From society's point of view, the economic function of profits and losses is to

A. promote the equal distribution of real assets and wealth.
B. achieve full employment and price level stability.
C. contribute to a more equal distribution of income.
D. reallocate resources from less-desired to more-desired uses.

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Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress. Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: 1
Topic: Five Fundamental Questions
Topic: The Invisible Hand

35. In a market economy, a significant change in consumers' desire for product X will

A. alter the profits or losses received by suppliers of product X.
B. cause a reallocation of scarce resources.
C. cause some industries to expand and others to contract.
D. do all of the things mentioned in the other answers.

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Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress. Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: 1
Topic: Five Fundamental Questions Topic: The Invisible Hand

36. Economic profits in an industry suggest the industry

A. can earn more profits by increasing product price.
B. should be larger to better satisfy consumers' desire for the product.
C. has excess production capacity.
D. is the size that consumers want it to be.

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Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: 1
Topic: Five Fundamental Questions

37. Economic profits and losses

A. are both considered by economists to be a part of production costs.
B. are essential to the reallocation of resources from less desired to more desired goods.
C. have no influence on the composition of domestic output.
D. equalize the distribution of income in the long run.

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Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress. Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: 1
Topic: Five Fundamental Questions
Topic: The Invisible Hand

38. If consumer desire for product X increases, all of the following will occur *except*

A. an increase in the profits of industry X.
B. an increase in the quantity of resources employed by industry X.
C. an increase in the output of industry X.
D. a decrease in the quantity of resources employed in industry X.

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Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress. Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
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Topic: Five Fundamental Questions
Topic: The Invisible Hand

39. An increase in consumer desire for strawberries is most likely to

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A. increase the number of strawberry pickers needed by farmers.
B. reduce the supply of strawberries.
C. reduce the number of people willing to pick strawberries.
D. reduce the need for strawberry pickers.

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Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress. Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: 1
Topic: Five Fundamental Questions
Topic: The Invisible Hand

40. If competitive industry Y is incurring substantial losses, output will

A. expand as resources move toward industry Y.
B. contract as resources move toward industry Y.
C. contract as resources move away from industry Y.
D. expand as resources move away from industry Y.

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Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress. Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: 1
Topic: Five Fundamental Questions
Topic: The Invisible Hand

41. The economic function of profits and losses is to

A. bring about a more equal distribution of income.
B. signal that resources should be reallocated.
C. eliminate small firms and reduce competition.
D. tell government which industries need to be subsidized.

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Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: 1
Topic: Five Fundamental Questions
Topic: The Invisible Hand

42. If a competitive industry is neither expanding nor contracting, we would expect

A. total revenue to be zero.
B. economic profits to be zero.
C. total opportunity cost to be zero.
D. more resources to flow to that industry.

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Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: 1
Topic: Five Fundamental Questions

43. The competitive market system

A. encourages innovation because government provides tax breaks and subsidies to those who develop new products or new productive techniques.
B. discourages innovation because it is difficult to acquire additional capital in the form of new machinery and equipment.
C. discourages innovation because firms want to get all the profits possible from existing machinery and equipment.
D. encourages innovation because successful innovators are rewarded with economic profits.

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Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: 1
Topic: Five Fundamental Questions

44. In a market economy, the distribution of output will be determined primarily by

A. consumer needs and preferences.
B. the quantities and prices of the resources that households supply.
C. government regulations that provide a minimum income for all.
D. a social consensus as to which distribution of income is most equitable.

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Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: 1
Topic: Five Fundamental Questions

45. The most efficient combination of resources in producing a given output is the combination that

A. comes closest to using the same quantities of land, labor, capital, and entrepreneurial ability.
B. minimizes the cost per unit of output.
C. uses the smallest total quantity of all resources.
D. conserves most on the use of labor.

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Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: 1
Topic: Five Fundamental Questions

46. Firms are motivated to minimize production costs because

A. it is the most environmentally friendly way to produce goods.
B. least-cost production techniques use the smallest total quantity of resources.
C. competitive pressures in the market will drive out higher-cost producers.
D. the government provides tax credits and subsidies to low-cost producers.

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47.

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Answer the question using the following data, which show all available techniques for producing 20 units of a particular commodity

Resource	Resource prices	Possible production Techniques				
		#1	#2	#3	#4	#5
Land	$4	2	4	2	4	4
Labor	3	1	2	4	1	3
Capital	3	5	2	3	1	2
Entrepreneurial Ability	2	3	1	1	4	1

In view of the indicated resource prices, the economically most efficient production technique(s) is (are) technique(s)

A. 1.
B. 2 and 4.
C. 3.
D. 1 and 3.

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Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: 1
Topic: Five Fundamental Questions

48.

Answer:the question using the following data, which show all available techniques for producing 20 units of a particular commodity

Resource	Resource prices	Possible production Techniques				
		#1	#2	#3	#4	#5
Land	$4	2	4	2	4	4
Labor	3	1	2	4	1	3
Capital	3	5	2	3	1	2
Entrepreneurial Ability	2	3	1	1	4	1

Assuming that the firm is motivated by self-interest and that the 20 units that can be produced with each technique can be sold for $2 per unit, the firm will

A. realize an economic profit of $10.
B. realize an economic profit of $4.
C. not earn any economic profit.
D. shut down rather than incur a loss by producing.

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Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: 1
Topic: Five Fundamental Questions

49.

Answer the question using the following data, which show all available techniques for producing 20 units of a particular commodity

Resource	Resource prices	Possible production Techniques				
		#1	#2	#3	#4	#5
Land	$4	2	4	2	4	4
Labor	3	1	2	4	1	3
Capital	3	5	2	3	1	2
Entrepreneurial Ability	2	3	1	1	4	1

If a new production technique is developed that enables a firm to produce 20 units of output with 3 units of land, 3 of labor, 1 of capital, and 2 of entrepreneurial ability, this technique would

A. not be adopted because, although it reduces production costs, it does not increase profit.
B. be adopted because it would lower production costs and increase economic profit.
C. not be adopted because it entails higher production costs than other available techniques.
D. be adopted, even though economic profits would be reduced slightly.

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Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: 1
Topic: Five Fundamental Questions

50.

Answer the question on the basis of the following information: Suppose 30 units of product A can be produced by employing just labor and capital in the four ways shown below. Assume the prices of labor and capital are $2 and $3, respectively.

	Production Techniques:			
	I	II	III	IV
Labor	4	3	2	5
Capital	2	3	5	1

Which technique is economically most efficient in producing A?

A. I
B. II
C. III
D. IV

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51.

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Answer the question on the basis of the following information: Suppose 30 units of product A can be produced by employing just labor and capital in the four ways shown below. Assume the prices of labor and capital are $2 and $3, respectively.

	Production Techniques:			
	I	II	III	IV
Labor	4	3	2	5
Capital	2	3	5	1

If the price of product A is $0.50, the firm will realize

A. an economic profit of $4.
B. an economic profit of $2.
C. an economic profit of $6.
D. a loss of $3.

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Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: 1
Topic: Five Fundamental Questions

52. In a competitive market economy, firms select the least-cost production technique because

A. such choices will result in full employment of available resources.
B. to do so will maximize the firms' profits.
C. this will prevent new firms from entering the industry.
D. "dollar voting" by consumers mandates such a choice.

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Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: 1
Topic: Five Fundamental Questions

53. The market system's answer to the fundamental question "What will be produced?" is essentially

A. "Goods and services that are profitable."
B. "Low-cost goods and services."
C. "Goods and services that can be produced using large amounts of capital."
D. "Goods and services that possess lasting value."

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Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: 1
Topic: Five Fundamental Questions

54. The market system's answer to the fundamental question "How will the goods and services be produced?" is essentially

A. "With as much machinery as possible."
B. "Using the latest technology."
C. "By exploiting labor."
D. "In ways that minimize the cost per unit of output."

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Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: 1
Topic: Five Fundamental Questions

55. The market system's answer to the fundamental question "Who will get the goods and services?" is essentially

A. "Those most willing and able to pay for them."
B. "Those who physically produced them."
C. "Those who most need them."
D. "Those who get utility from them."

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Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: 1
Topic: Five Fundamental Questions

56. The market system's answer to the fundamental question "How will the system accommodate change?" is essentially

A. "Through government leadership and direction."
B. "Through the guiding function of prices and the incentive function of profits."
C. "Through training and retraining programs."
D. "Through trial and error."

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Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: 1
Topic: Five Fundamental Questions

57. The market system's answer to the fundamental question "How will the system promote progress?" is essentially

A. "Through government-funded research programs."
B. "Through redistribution of income to promote greater equality."
C. "Through training and retraining programs."
D. "Through the profit potential that encourages development of new technology."

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Topic: Five Fundamental Questions

58. The advent of Netflix movie streaming and Redbox kiosks renting DVD and Blu-ray movies have virtually demolished the market for video rentals from brick and mortar stores such as Blockbuster. This is an example of

A. creative destruction.
B. derived demand.
C. capital accumulation.

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D. the difference between normal and economic profits.

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Test Bank: 1
Topic: Five Fundamental Questions

59. "Consumer sovereignty" refers to the

A. fact that resource prices are higher than product prices in capitalistic economies.
B. idea that the pursuit of self-interest is in the public interest.
C. idea that the decisions of producers must ultimately conform to consumer demands.
D. fact that a federal agency exists to protect consumers from harmful and defective products.

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Test Bank: 1
Topic: Five Fundamental Questions

60. The dollar votes of consumers ultimately determine the composition of output and the allocation of resources in a market economy. This statement best describes the concept of

A. derived demand.
B. consumer sovereignty.
C. the invisible hand.
D. market failure.

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Test Bank: 1
Topic: Five Fundamental Questions

61. Which of the following is *not* one of the five fundamental questions?

A. What prices will be charged for goods and services?
B. Who will get the goods and services?
C. What goods and services will be produced?
D. How will the system promote progress?

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Test Bank: 1
Topic: Five Fundamental Questions

62. "Consumer sovereignty" means that

A. buyers can dictate the prices at which goods and services will be offered.
B. advertising is ineffective because consumers already know what they want.
C. buyers control the quality of goods and services through regulatory agencies.
D. buyers determine what will be produced based on their "dollar votes" for the goods and services offered by sellers.

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Test Bank: 1
Topic: Five Fundamental Questions

63. Which of the following best describes the invisible-hand concept?

A. The desires of resource suppliers and producers to further their own self-interest will automatically further the public interest.
B. The inability to substitute resources creates a conflict between private and public interests and calls for government intervention.
C. The market system is the best system for overcoming the scarce resources-unlimited wants problem.
D. Central direction by the government will improve resource allocation in a capitalistic economy.

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Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: 1
Topic: The Invisible Hand

64. The invisible hand refers to the

A. fact that the U.S. tax system redistributes income from rich to poor.
B. notion that, under competition, decisions motivated by self-interest promote the social interest.
C. tendency of monopolistic sellers to raise prices above competitive levels.
D. fact that government controls the functioning of the market system.

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Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: 1
Topic: The Invisible Hand

65. The invisible hand concept suggests that

A. market failures imply the need for a national economic plan.
B. big businesses are inherently more efficient than small businesses.
C. the competitiveness of a capitalistic market economy invariably diminishes over time.
D. assuming competition, private and public interests will coincide.

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Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: 1
Topic: The Invisible Hand

66. Two major virtues of the market system are that it

A. allocates resources efficiently and allows economic freedom.
B. results in an equitable personal distribution of income and always maintains full employment.
C. results in price-level stability and a fair personal distribution of income.
D. eliminates discrimination and minimizes environmental pollution.

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Difficulty: 02 Medium
Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: 1
Topic: The Invisible Hand

67. The market system

A. produces considerable inefficiency in the use of scarce resources.
B. effectively harnesses the incentives of workers and entrepreneurs.
C. is not consistent with freedom of choice in the long run.
D. has slowly lost ground to emerging command systems.

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Difficulty: 02 Medium
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Test Bank: 1
Topic: The Invisible Hand

68. According to the concept of the "invisible hand," if Susie opens and operates a profitable childcare center, then

A. government should regulate the business to ensure quality.
B. the profit Susie earns indicates that she is overcharging for her services.
C. she has served society's interests by providing a desired good or service.
D. this demonstrates that consumer sovereignty is not present in this market.

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Test Bank: 1
Topic: The Invisible Hand

69. The invisible hand promotes society's interests because

A. individuals pursuing their self-interest will try to produce goods and services that people in society want and are willing to purchase.
B. individuals will produce goods for others out of concern for their fellow human beings.
C. it makes sure that everyone wins from competition in the market.
D. government regulation pushes business into producing the right mix of goods and services.

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Test Bank: 1
Topic: The Invisible Hand

70. The coordination problem in the centrally planned economies refers to the idea that

A. planners had to direct required inputs to each enterprise.
B. the price level and the level of employment were inversely related.
C. the immediate effect of more investment was less consumption.
D. exports had to be equal to imports for a central plan to work.

AACSB: Analytical Thinking
Accessibility: Keyboard Navigation
Blooms: Analyze
Difficulty: 03 Hard
Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system. Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: 1
Topic: Economic Systems

71. "Under central planning, some group has to decide how to get the necessary inputs produced in the right amounts and delivered to the right places at the right time. This is a nearly impossible task without markets and profits." This quotation best identifies the

A. incentive problem under central planning.
B. coordination problem under central planning.
C. self-sufficiency dilemma under communism.
D. resource overcommitment problem under communism.

AACSB: Analytical Thinking
Accessibility: Keyboard Navigation
Blooms: Analyze
Difficulty: 03 Hard
Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system.
Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: 1
Topic: Economic Systems

72. "Because the outputs of many industries are the inputs to other industries, the failure of any single industry to fulfil the output quantities specified in the central plan caused a chain reaction of adverse repercussions on production." This quotation best identifies the

A. incentive problem under central planning.
B. self-sufficiency dilemma under communism.
C. resource overcommitment problem under communism.
D. coordination problem under central planning.

AACSB: Analytical Thinking
Accessibility: Keyboard Navigation
Blooms: Analyze
Difficulty: 03 Hard
Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system.
Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: 1
Topic: Economic Systems

73. The incentive problem under communist central planning refers to the idea that

A. planners had to direct required inputs to each enterprise.
B. workers, managers, and entrepreneurs could not personally gain by responding to shortages or surpluses or by introducing new and improved products.
C. the immediate effect of more investment was less consumption.
D. exports had to be equal to imports for a central plan to work.

AACSB: Analytical Thinking
Accessibility: Keyboard Navigation
Blooms: Analyze
Difficulty: 03 Hard
Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system.
Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: 1
Topic: Economic Systems

74. Suppose that an individual sees a tremendous opportunity to produce and sell a new product but dismisses the idea because there is no way to exploit this opportunity for personal gain. This situation best identifies the

A. coordination problem under communist central planning.
B. self-sufficiency dilemma under communism.
C. asymmetric information problem under communism.
D. incentive problem under communist central planning.

AACSB: Analytical Thinking
Accessibility: Keyboard Navigation
Blooms: Analyze
Difficulty: 03 Hard

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Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system. Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: 1
Topic: Economic Systems

75. Innovation lagged in the centrally planned economies because

A. there was too much domestic business competition.
B. there was too much competition from foreign firms.
C. enterprises resisted innovation in fear that their production targets would be raised.
D. exports had to equal imports for the plan to work.

AACSB: Analytical Thinking
Accessibility: Keyboard Navigation
Blooms: Analyze
Difficulty: 03 Hard
Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system.
Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: 1
Topic: Economic Systems

76. The fact that the major indicator of enterprise success in the Soviet Union and pre-reform China was the quantity of output implied that

A. product quality was neglected.
B. production costs were minimized.
C. product mix met consumer needs.
D. technological advance was too rapid.

AACSB: Analytical Thinking
Accessibility: Keyboard Navigation
Blooms: Analyze
Difficulty: 03 Hard
Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system.
Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: 1
Topic: Economic Systems

77. Enterprise managers and workers in the Soviet Union often resisted innovations in production methods because

A. production targets were often increased when innovation occurred.
B. there was a chronic shortage of computers.
C. workers could not be reallocated geographically.
D. innovations ordinarily increased dependence on world markets.

AACSB: Analytical Thinking
Accessibility: Keyboard Navigation
Blooms: Analyze
Difficulty: 03 Hard
Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system.
Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: 1
Topic: Economic Systems

78. If products were in short or surplus supply in the Soviet Union,

A. price and profit signals eliminated those shortages and surpluses.
B. price and profit signals intensified those shortages and surpluses.
C. producers would not react because no price or profit signals occurred.
D. the planners would immediately adjust production to achieve equilibrium.

AACSB: Analytical Thinking
Accessibility: Keyboard Navigation
Blooms: Analyze
Difficulty: 03 Hard
Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system.
Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: 1
Topic: Economic Systems

79. In what type of business do the owners bear no personal financial responsibility for the company's debts and obligations?

A. partnerships
B. corporations
C. sole proprietorships
D. in all of the businesses listed in the other answers

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: 1
Topic: The Circular Flow Model

80. The simple circular flow model shows that

A. households are on the buying side of both product and resource markets.
B. businesses are on the selling side of both product and resource markets.
C. households are on the selling side of the resource market and on the buying side of the product market.
D. businesses are on the buying side of the product market and on the selling side of the resource market.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: 1
Topic: The Circular Flow Model

81. The two basic markets shown by the simple circular flow model are

A. capital goods and consumer goods.
B. competitive and regulated.
C. product and resource.
D. household and business.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: 1
Topic: The Circular Flow Model

82. In the resource market,

A. businesses borrow financial capital from households.
B. businesses sell services to households.
C. households sell resources to businesses.
D. firms sell raw materials to households.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium

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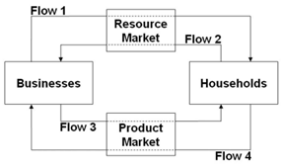
Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: 1
Topic: The Circular Flow Model

83. In the simple circular flow model,

A. households are buyers of resources.
B. businesses are sellers of final products.
C. households are sellers of final products.
D. there are real flows of goods, services, and resources, but not money flows.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: 1
Topic: The Circular Flow Model

84.

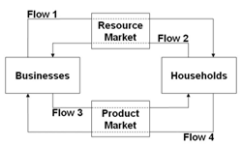


Refer to the diagram. Flow 1 represents

A. wage, rent, interest, and profit income.
B. land, labor, capital, and entrepreneurial ability.
C. goods and services.
D. consumer expenditures.

AACSB: Knowledge Application
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: 1
Topic: The Circular Flow Model

85.

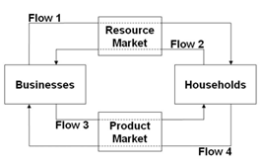


Refer to the diagram. Flow 2 represents

A. wage, rent, interest, and profit income.
B. land, labor, capital, and entrepreneurial ability.
C. goods and services.
D. consumer expenditures.

AACSB: Knowledge Application
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: 1
Topic: The Circular Flow Model

86.



Refer to the diagram. Flow 3 represents

A. wage, rent, interest, and profit income.
B. land, labor, capital, and entrepreneurial ability.
C. goods and services.
D. consumer expenditures.

AACSB: Knowledge Application
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: 1
Topic: The Circular Flow Model

87.

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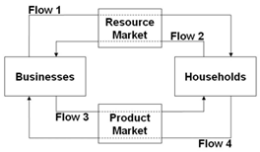

Refer to the diagram. Flow 4 represents

A. wage, rent, interest, and profit income.
B. land, labor, capital, and entrepreneurial ability.
C. goods and services.
D. consumer expenditures and business revenue.

AACSB: Knowledge Application
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: 1
Topic: The Circular Flow Model

88. In terms of the circular flow diagram, households make expenditures in the_____market and receive income through the_____market.

A. product; financial
B. resource; product
C. product; resource
D. capital; product

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: 1
Topic: The Circular Flow Model

89. In terms of the circular flow diagram, businesses obtain revenue through the_____market and make expenditures in the_____market.

A. product; financial
B. resource; product
C. product; resource
D. capital; product

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: 1
Topic: The Circular Flow Model

90. Households and businesses are

A. both buyers in the resource market.
B. both sellers in the product market.
C. sellers in the resource and product markets respectively.
D. sellers in the product and resource markets respectively.

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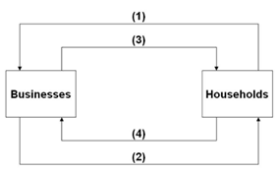
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: 1
Topic: The Circular Flow Model

91.

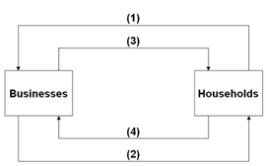


Refer to the diagram. Arrows (1) and (2) represent

A. goods and resources, respectively.
B. money incomes and output, respectively.
C. output and money incomes, respectively.
D. resources and goods, respectively.

AACSB: Knowledge Application
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: 1
Topic: The Circular Flow Model

92.



Refer to the diagram. Arrows (3) and (4) represent

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A. goods and services, respectively.
B. incomes and consumer expenditures, respectively.
C. resources and goods, respectively.
D. consumer expenditures and income, respectively.

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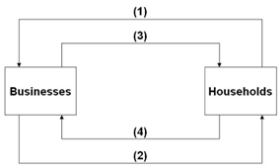
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: 1
Topic: The Circular Flow Model

93.



Refer to the diagram. Arrows (1) and (3) are associated with

A. the money market.
B. the resource market.
C. the product market.
D. international trade.

AACSB: Knowledge Application
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: 1
Topic: The Circular Flow Model

94. Which of the following best illustrates the circular flow model in action?

A. Bobbie goes to work and builds cars; she uses the income she receives to buy food at the grocery store.
B. Evan buys a new couch; the owner of the furniture store uses some of the money from the sale to pay her supplier and uses the rest to take her family out to dinner.
C. Boeing experiences a surge in orders for new airplanes, prompting the company to hire more workers.
D. All of these answers illustrate the workings of the circular flow model.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: 1
Topic: The Circular Flow Model

95. Risk is a problem faced

A. only in market systems.
B. only in command systems.
C. in both market systems and command systems.
D. in neither market systems nor command systems, only in laissez-faire capitalism.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-06 Explain how the market system deals with risk.
Test Bank: 1
Topic: How the Market System Deals with Risk

96. Which of the following statements is true about risk management in market systems versus command systems?

A. Market systems manage risk better because entrepreneurs taking risks bear the costs of poor decisions, whereas in command systems government decision makers don't bear those costs.
B. Neither system is better than the other in terms of risk management; both systems are equally susceptible to natural disasters and changes in consumer preferences.
C. Command systems manage risk better because the government controls most economic activity and can therefore eliminate risk.
D. Market systems face risk because of the possibility of profits and losses; command systems don't face risk because they are not profit driven.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-06 Explain how the market system deals with risk.
Test Bank: 1
Topic: How the Market System Deals with Risk

97. Risk management in command economies

A. is easy because there is no risk.
B. is easy because the government controls most activity and can eliminate risk.
C. tends to be done poorly because government officials do not understand risk.
D. tends to be done poorly because decision makers are insulated from the risk of making a poor decision.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-06 Explain how the market system deals with risk.
Test Bank: 1
Topic: How the Market System Deals with Risk

98. In a market system,

A. firm owners and employees share business risk more or less equally.
B. a firm's employees and suppliers are largely shielded from risk, relative to business owners.
C. employees and suppliers face the greatest risks, because firms can shut down without notice and leave them unpaid.
D. a firm's owners are largely shielded from risk because they can walk away from the business at any time.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-06 Explain how the market system deals with risk.
Test Bank: 1
Topic: How the Market System Deals with Risk

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99. In a market system, employees and suppliers

A. are usually shielded from risk, but at the cost of not sharing in the profits of the firm.
B. are usually shielded from risk and share in the profits of the firm.
C. are generally subject to as much risk as firm owners but get to share in the profits.
D. bear as much risk as firm owners but don't get to share in the profits.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-06 Explain how the market system deals with risk.
Test Bank: 1
Topic: How the Market System Deals with Risk

100. A market system tends to restrict business risk to owners and investors. This results in which of the following benefits?

A. a more stable macroeconomy with fewer recessions
B. Firms are better able to attract inputs, as these inputs do not have to share the risk.
C. Government agencies are better prepared to help when businesses fail.
D. consistently lower prices for consumers

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-06 Explain how the market system deals with risk.
Test Bank: 1
Topic: How the Market System Deals with Risk

101. A market system tends to restrict business risk to owners and investors. This results in which of the following benefits?

A. It encourages more people to become entrepreneurs.
B. Firms have to pay more to attract inputs, as these inputs have to share the risk.
C. Firms focus attention on prudent risk management, as it is profitable to manage risk.
D. Income becomes more equally distributed.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-06 Explain how the market system deals with risk.
Test Bank: 1
Topic: How the Market System Deals with Risk

102. (Consider This) In 1975, McDonald's introduced its Egg McMuffin breakfast sandwich, which remains popular and profitable today. This longevity illustrates the idea of

A. opportunity cost.
B. upsloping supply.
C. consumer sovereignty.
D. specialization.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: 1
Topic: Five Fundamental Questions

103. (Consider This) In 2013, McDonald's introduced Fish McBites, which failed to catch on with the public and was subsequently dropped from the menu. This failure illustrates the idea of

A. consumer sovereignty.
B. technological change.
C. downsloping demand.
D. specialization.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: 1
Topic: Five Fundamental Questions

104. (Consider This) Since World War II,

A. North Korea's command economy has significantly outperformed South Korea's market economy.
B. South Korea's command economy has significantly outperformed North Korea's market economy.
C. North Korea's market economy has significantly outperformed South Korea's command economy.
D. South Korea's market economy has significantly outperformed North Korea's command economy.

AACSB: Analytical Thinking
Accessibility: Keyboard Navigation
Blooms: Analyze
Difficulty: 03 Hard
Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system. Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: 1
Topic: Economic Systems

105. (Consider This) North Korea's command economy

A. is one of the few remaining command economies.
B. has grown much faster than South Korea's economy since the two countries were divided after World War II.
C. produces a per capita GDP of nearly $25,000.
D. has undergone significant market reforms and is now one of the fastest-growing economies.

AACSB: Analytical Thinking
Accessibility: Keyboard Navigation
Blooms: Analyze
Difficulty: 03 Hard
Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system.
Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: 1
Topic: Economic Systems

106. (Consider This) Which of the following statements about insurance and risk is true?

A. Insurance inhibits economic growth and investment by discouraging risk-taking.
B. Insurance transfers risk from those with a high tolerance for risk to those with a low tolerance for risk.
C. Insurance companies always earn profits because insurance premiums always exceed the payout for insured events.
D. Insurance transfers risk from those with a low tolerance for risk to those with a higher tolerance for risk.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-06 Explain how the market system deals with risk.
Test Bank: 1
Topic: How the Market System Deals with Risk

107. (Consider This) Martha's Milkshake Company buys earthquake insurance from the Stable Ground Insurance Company. Based on this purchase, economists would conclude that

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A. Martha's believes a damaging earthquake is imminent.
B. Stable Ground believes no damaging earthquakes will occur.
C. Martha's has a lower tolerance for earthquake risk than Stable Ground.
D. Martha's has a greater tolerance for earthquake risk than Stable Ground.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-06 Explain how the market system deals with risk.
Test Bank: 1
Topic: How the Market System Deals with Risk

108. (Last Word) According to economist Donald Boudreaux, the world's tens of billions of individual resources get arranged productively

A. because government has become highly effective at central planning.
B. because private property encourages people to consider the alternative uses of their resources and select those that provide the most rewards.
C. because people tend to be creative and orderly.
D. through random trial and error.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: 1
Topic: Characteristics of the Market System

109. (Last Word) According to economist Donald Boudreaux,

A. private property eliminates the possibility that resource arrangements will be random.
B. the market system threatens to do irreparable harm to the world's ecosystem.
C. arranging resources under the market system is much like shuffling a deck of cards.
D. the market system works wondrously for advanced industrial nations but not for developing nations.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: 1
Topic: Characteristics of the Market System

True / False Questions

110. Market economies use capital goods because they improve productive efficiency.

TRUE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: 1
Topic: Characteristics of the Market System

111. Money functions as a medium of exchange by eliminating the need for a coincidence of wants.

TRUE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: 1
Topic: Characteristics of the Market System

112. Consumer sovereignty means that legislation now protects the rights of consumers to dispose of their incomes as they see fit.

FALSE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: 1
Topic: Five Fundamental Questions

113. Specialization may expand total output even though the individuals involved may have identical abilities.

TRUE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: 1
Topic: Characteristics of the Market System

114. The wants of consumers are expressed in the product market with "dollar votes."

TRUE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: 1
Topic: Five Fundamental Questions

115. Costs can be defined as total payments made to workers, landowners, and capital suppliers *less* payments to the entrepreneur for organizing and combining the other resources used to produce a good.

FALSE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: 1
Topic: Five Fundamental Questions

116. Continued losses in an industry will cause some firms to reduce output or eventually leave the industry.

TRUE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand

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Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: I
Topic: Five Fundamental Questions

117. The guiding function of prices tends to keep resources flowing toward their most highly valued uses.

TRUE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: I
Topic: Five Fundamental Questions

118. The invisible hand refers to the many indirect controls that the federal government imposes in a market system.

FALSE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: I
Topic: The Invisible Hand

119. Central planning in the Soviet Union and pre-reform China emphasized expanding the production of consumer goods to raise the domestic standard of living.

FALSE

AACSB: Analytical Thinking
Accessibility: Keyboard Navigation
Blooms: Analyze
Difficulty: 03 Hard
Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system.
Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: I
Topic: Economic Systems

120. Central planning often suffers from a coordination problem and an incentive problem.

TRUE

AACSB: Analytical Thinking
Accessibility: Keyboard Navigation
Blooms: Analyze
Difficulty: 03 Hard
Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system.
Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: I
Topic: Economic Systems

Multiple Choice Questions

121. Economic systems differ from one another based on who owns the factors of production and

A. how many resources are available in the economy and where they are located.
B. how economic activities are coordinated and directed.
C. what kinds of products are produced in the economy and how they are sold.
D. how big the population is and the makeup of the population.

AACSB: Analytical Thinking
Accessibility: Keyboard Navigation
Blooms: Analyze
Difficulty: 03 Hard
Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system.
Test Bank: II
Topic: Economic Systems

122. The market system is an economic system that

A. produces more consumer goods than capital goods.
B. produces more capital goods than consumer goods.
C. gives private individuals the right to own resources used in production.
D. emphasizes the government's power to control markets and direct economic activity.

AACSB: Analytical Thinking
Accessibility: Keyboard Navigation
Blooms: Analyze
Difficulty: 03 Hard
Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system.
Test Bank: II
Topic: Economic Systems

123. The market system is also known as _, while the command system is also known as _.

A. capitalism; socialism
B. socialism; communism
C. central planning; laissez faire
D. a production system; a planning system

AACSB: Analytical Thinking
Accessibility: Keyboard Navigation
Blooms: Analyze
Difficulty: 03 Hard
Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system.
Test Bank: II
Topic: Economic Systems

124. Laissez-faire capitalism limits the government's economic functions to the following, *except*

A. protecting private property rights.
B. establishing a legal environment to enforce contracts among individuals.
C. preventing individuals and firms from coercing others.
D. setting prices of individual goods and services.

AACSB: Analytical Thinking
Accessibility: Keyboard Navigation
Blooms: Analyze
Difficulty: 03 Hard
Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system.
Test Bank: II
Topic: Economic Systems

125. One major element of the command system is

A. an emphasis on private ownership of resources.
B. individual decentralized decision making.
C. reliance on supply-and-demand forces to guide economic activity.
D. central planning conducted by the government.

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AACSB: Analytical Thinking
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Blooms: Analyze
Difficulty: 03 Hard
Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system.
Test Bank: II
Topic: Economic Systems

126. The government may impose industrial safety regulations and occupational licensing requirements in which of the following economic systems?

A. laissez-faire economy
B. pure capitalism
C. mixed-market economy
D. macroeconomic system

AACSB: Analytical Thinking
Accessibility: Keyboard Navigation
Blooms: Analyze
Difficulty: 03 Hard
Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system.
Test Bank: II
Topic: Economic Systems

127. In a command system,

A. self-interest motivates and commands each business firm's decisions and actions.
B. the head of each family decides and commands what to do with the family's resources.
C. a government-appointed planning board makes production and allocation decisions.
D. market traders command what outputs are produced and how they are allocated.

AACSB: Analytical Thinking
Accessibility: Keyboard Navigation
Blooms: Analyze
Difficulty: 03 Hard
Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system.
Test Bank: II
Topic: Economic Systems

128. Which of the following would *not* be emphasized in a capitalist economy?

A. private ownership of capital and other resources
B. competition and decentralized decisions regarding production and consumption
C. reliance on market forces to coordinate economic activity
D. prevention of firms from exposing themselves to financial risk

AACSB: Analytical Thinking
Accessibility: Keyboard Navigation
Blooms: Analyze
Difficulty: 03 Hard
Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system.
Test Bank: II
Topic: Economic Systems

129. The government may not implement policies intended to redistribute income in which of the following economic systems?

A. laissez-faire capitalism
B. command system
C. mixed economy
D. market system

AACSB: Analytical Thinking
Accessibility: Keyboard Navigation
Blooms: Analyze
Difficulty: 03 Hard
Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system.
Test Bank: II
Topic: Economic Systems

130. The economies of North Korea and Cuba are

A. similar in that they are both basically command systems.
B. similar in that they are both basically market systems.
C. different in that North Korea has a command system, while Cuba has a market system.
D. different in that Cuba has a command system, while North Korea has a market system.

AACSB: Analytical Thinking
Accessibility: Keyboard Navigation
Blooms: Analyze
Difficulty: 03 Hard
Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system.
Test Bank: II
Topic: Economic Systems

131. *Laissez-faire* capitalism is characterized by

A. very limited government role in the economy.
B. active government intervention in the economy.
C. individuals and firms abiding by a government economic plan.
D. the economic system of the United States today.

AACSB: Analytical Thinking
Accessibility: Keyboard Navigation
Blooms: Analyze
Difficulty: 03 Hard
Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system.
Test Bank: II
Topic: Economic Systems

132. By freedom of enterprise, we mean that individual

A. workers are free to look for jobs and work in whichever firm will hire them.
B. firms are free to employ resources, to produce their output, and to sell their products.
C. producers are free to produce whatever the government decides is needed by the society.
D. consumers are free to buy whatever products will satisfy their needs the most.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

133. Capitalism gets its name from the fact that capital resources are mostly

A. owned by the state or government.
B. given the highest priority in the economy's income distribution.
C. treated as private property.
D. in the form of money and financial resources.

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Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy

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Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

134. The main characteristics of a modern market system include all of the following *except*

A. entrepreneurs are free to obtain and use resources to produce goods and services.
B. consumers are free to buy goods and services that their budgets allow.
C. economic power is diffused by competition among economic units.
D. government is restricted to national defense and does not intervene at all in various markets.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

135. In a market system, self-interest is the motivating force that

A. makes individuals unwilling to deliver anything of value to others.
B. makes owners of resources always want to use their resources themselves.
C. leads the economy to chaos and confusion, especially the larger economies.
D. coordinates and creates consistency in the operations of various parts of the economy.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

136. Which of the following statements about self-interest in a market system is false?

A. Self-interest usually motivates an individual to deliver something of value to others.
B. Self-interest of entrepreneurs implies seeking maximum profits or minimum losses.
C. Self-interest applies only to capitalists and entrepreneurs, not to workers employed by others.
D. In a market system, consumers are just like firms: self-interest is what motivates them.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

137. Consumers express self-interest when they

A. seek the lowest price for a product.
B. reduce business losses.
C. collect economic profits.
D. exclude others in their thinking.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

138. Private property and freedom of choice in a market system have the following implications, *except*

A. individuals are free to take on the financial risks involved in a business.
B. trades that take place in the economy are mutually agreeable transactions among individuals.
C. economic agents are allowed to act in their own self-interest.
D. large firms are allowed to coerce other firms and individuals.

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Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

139. Which of the following statements about the right to private ownership is false?

A. It enables individuals to obtain, use, and dispose of land and capital resources as they see fit.
B. It encourages investment and innovation, and thus fosters economic growth.
C. It extends to intangibles such as pieces of music and computer programs.
D. It weakens the incentive to maintain the property that one already owns.

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Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

140. Competition is more likely to exist when

A. there is easy entry into and exit out of industries.
B. a government-issued license is required to set up a firm in an industry.
C. the government purchases most goods and services.
D. economic power is concentrated among a few large firms.

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Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

141. Competition in a market system denotes a condition where

A. the diffusion of economic power limits its potential abuse.
B. any given product can be purchased at a wide range of prices.
C. contractual agreements among individual firms are restricted and avoided.
D. a few large, dominant sellers are constantly jostling for market share.

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Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

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142. Which of the following statements about markets and prices is correct?

A. In a market system, buyers and sellers must be in face-to-face contact with each other.
B. Prices affect the distribution of goods in a market system, but not the allocation of resources.
C. In a market system, prices serve to ration goods and services to consumers.
D. The operation of a market system has little, if any, effect on the distribution of income in the economy.

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Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

143. In a capitalist system, the decisions and actions of millions of consumers and firms are highly coordinated by

A. the state and government.
B. markets and prices.
C. a central planning agency.
D. an international organization.

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Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

144. All of the following statements describe a market economy *except*

A. government prescribes the market prices for goods and services.
B. prices provide important signals to buyers and sellers.
C. the allocation of resources is determined by their prices.
D. the actions of buyers and sellers establish a product's price.

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Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

145. A characteristic of the market system is

A. extensive use of direct or manual methods of production.
B. a focus on labor, as opposed to capital resources.
C. reliance on the use of capital goods in indirect modes of production.
D. avoidance of producing goods that do not satisfy consumer wants directly.

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Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

146. Which of the following does not foster innovation and technological advance?

A. competition in markets
B. freedom of choice and enterprise
C. self-interest and personal rewards
D. fear and avoidance of risk

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

147. The Heritage Foundation in 2015 ranked which of the following economies to have the highest economic freedom?

A. the United States
B. Germany
C. Japan
D. Hong Kong

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Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

148. A production system where various workers concentrate on different specialized tasks to contribute toward a whole product is referred to as

A. a coincidence of wants.
B. roundabout production.
C. freedom of enterprise
D. division of labor.

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Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

149. How does human specialization contribute toward increasing an economy's output?

A. It exploits the differences in abilities.
B. It is a process of creative destruction.
C. It pushes each worker to master the whole product.
D. It encourages people to be "jacks-of-all-trades."

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Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

150. With specialization in a market economy, individual

A. firms produce a wide range of products.
B. producers consume little or none of the products they produce.

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C. producers consume most of the output that they produce.
D. consumers have to produce most of what they consume.

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Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

151. Which of the following is *not* a reason why specialization and trade are beneficial to society?

A. The total output of economic goods may be increased even without any increase in resources.
B. Scarce resources are utilized more efficiently by exploiting differences among them.
C. Specialization fosters learning by doing, thus lowering the unit-costs of products.
D. Firms and workers become less dependent on others for producing goods and services.

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Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

152. A required element for specialization to lead to an increase in the satisfaction of society's wants is

A. a capitalist economy.
B. exchange and trade.
C. the use of money.
D. a central plan.

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Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

153. Specialization is beneficial

A. at the individual firm level, but not at the national and international levels.
B. at the individual, regional, and even international levels.
C. only if there are differences in the abilities of resources.
D. only as long as money and capital goods are employed.

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Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

154. Which is an example of barter?

A. a person trades a desk for a box of tools
B. a person buys clothes at a used clothing store
C. a gift of tuition money from parents to their children
D. the purchase of stock on the New York Stock Exchange

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

155. An economic system in which money is *not* used as a medium of exchange is a

A. planned economy.
B. market economy.
C. mixed economy.
D. barter economy.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

156. Which of the following is necessary to make a trade in a barter economy?

A. money
B. unlimited wants
C. a medium of exchange
D. a coincidence of wants

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

157. The use of money for exchange and trade

A. increases the importance of barter.
B. fosters more specialization in production.
C. reduces consumer sovereignty.
D. raises the need for a coincidence of wants.

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Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

158. Anything that is generally acceptable in trading for goods and services is a

A. medium of exchange.
B. capital good.
C. store of value.
D. resource.

AACSB: Knowledge Application

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Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

159. Which of the following is the main problem with the barter system of exchange?

A. It encourages self-interest.
B. It fosters the division of labor.
C. It requires a coincidence of wants.
D. It undermines the right to bequeath.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

160. International specialization and trade

A. has to be done on a barter system.
B. often requires the exchange of currencies.
C. does not illustrate the division of labor.
D. requires active government regulation.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

161. Why might a company use barter rather than money to make a trade?

A. Barter trade is generally more efficient than money-based trade.
B. Barter can enable two firms to trade when their cash flows are limited.
C. Money requires a coincidence of wants; barter is more direct.
D. Money is efficient only for large transactions, so barter is preferred for smaller transactions.

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Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

162. Which of the following is assumed to be most limited in scope under a market system?

A. entrepreneurship
B. self-interest
C. specialization
D. government

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Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

163. If a nation restricts trade with other nations, then the most likely effect is

A. lower prices of goods and services in the nation.
B. increased specialization of production.
C. expanded economic wealth of the nation.
D. consumers in the nation are made worse off.

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Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

164. Which is one of the five fundamental questions that need to be dealt with in any economic system?

A. What makes the rate of unemployment low?
B. Who will be the richest group in the economy?
C. How will goods and services be produced?
D. How high should the prices of goods and services be?

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: II
Topic: Five Fundamental Questions

165. Which of the following is *not* one of the five fundamental questions that an economy must deal with?

A. How will the goods and services be produced?
B. Why should the goods and services be produced?
C. Who is to receive the goods and services produced in the economy?
D. In what ways will progress be promoted?

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: II
Topic: Five Fundamental Questions

166. Consumer sovereignty and "dollar votes" guide the market system in dealing with which fundamental economic question?

A. Which output will be produced?
B. How is the output to be produced?
C. How can the system accommodate change?
D. Who is to receive the output?

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: II

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Topic: Five Fundamental Questions

167. The term *consumer sovereignty* means that

A. government is responsible for protecting consumers' interests.
B. what is produced is ultimately determined by what consumers buy.
C. there are no limits on what consumers may buy in a market system.
D. producers have strong control over what consumers buy.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: II
Topic: Five Fundamental Questions

168. The market system is said to be characterized by "consumer sovereignty." This is because

A. a sovereign government determines which consumer goods will be produced.
B. the prices of consumer goods are regulated by a sovereign government.
C. firms must match their production decisions to the consumers' choices.
D. consumer goods are considered to be more important than capital goods.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: II
Topic: Five Fundamental Questions

169. The term *dollar votes* in a market system means

A. inflation will occur if consumers don't spend wisely.
B. voters may be offered dollars to help elect certain political candidates.
C. government is responsible for determining what will be considered legal tender.
D. consumers "vote" for certain products to be produced by how they spend their incomes.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: II
Topic: Five Fundamental Questions

170. In a market system, the "What will be produced?" question is ultimately decided by

A. profitability of products.
B. costs of production.
C. workers in the firms.
D. industry analysts.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: II
Topic: Five Fundamental Questions

171. Payments that a firm makes to obtain needed resources comprise its

A. costs.
B. profits.
C. capital.
D. revenues.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: II
Topic: Five Fundamental Questions

172. In a market system, more resources will move toward an industry and expand its production if the industry has

A. positive revenues.
B. positive costs.
C. TC < TR.
D. TC > TR.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: II
Topic: Five Fundamental Questions

173. In a market system, if firms in an industry persistently earn total revenues that are less than total costs, then that industry will

A. have some firms go out of business.
B. attract more resources toward it.
C. experience entry of new firms.
D. get government protection from failure.

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Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: II
Topic: Five Fundamental Questions

174. In a market system, which of the following will eliminate high-cost producers and allow only the low-cost producers to survive?

A. competition
B. money
C. a sovereign government
D. specialization

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: II
Topic: Five Fundamental Questions

175. If the total costs of producing 1,500 units of output is $15,000 and this output sold to consumers for a total of $16,500, then the firm would earn profits of A.

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$31,500.
B. $16,500.
C. $1,500. D.
$15,000.

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176. The production technique that is most efficient is the one that produces a given amount of output

A. using the least amount of labor resources.
B. at the highest price per unit.
C. at the lowest cost per unit.
D. that yields the highest revenues.

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177. McDonald's introduced the Big Mac in 1968, and it turned out to be a hit. However, the Arch Deluxe, introduced in 1996, was not. The success or failure of a product in the market system is determined by

A. capitalism and entrepreneurship.
B. specialization and exchange.
C. consumer sovereignty and dollar votes.
D. capital goods and roundabout production.

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178. Economic efficiency is the primary guide in answering which of the fundamental questions in a market economy?

A. What will be produced?
B. How is the output to be produced?
C. How can the system accommodate change?
D. Who is to receive the output?

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179.

Suppose a firm can produce 70 units of a product, Zenia, by combining labor, land, capital, and entrepreneurial ability, as in the four alternative techniques shown in the table below. Assume further that the firm can hire labor at $3 per unit, land at $3 per unit, capital at $6 per unit, and entrepreneurship at $9 per unit.

	Techniques			
	A	B	C	D
Labor	4	10	6	5
Land	5	3	3	3
Capital	5	2	4	4
Entrepreneurship	1	1	1	1

Refer to the provided table. Which technique is the most economically efficient way of producing Zenia?

A. A
B. B
C. C
D. D

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Test Bank: II
Topic: Five Fundamental Questions

180.

Suppose a firm can produce 70 units of a product, Zenia, by combining labor, land, capital, and entrepreneurial ability, as in the four alternative techniques shown in the table below. Assume further that the firm can hire labor at $3 per unit, land at $3 per unit, capital at $6 per unit, and entrepreneurship at $9 per unit.

	Techniques			
	A	B	C	D
Labor	4	10	6	5
Land	5	3	3	3
Capital	5	2	4	4
Entrepreneurship	1	1	1	1

Refer to the provided table, and suppose that the firm uses production technique D. If each of the 70 units of Zenia that are produced sells for $1 apiece, then how much will be the total profits of the firm from 70 units of Zenia?

A. $70 B.
$57 **C.**
$13 D.
$83

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181.

Suppose a firm can produce 70 units of a product, Zenia, by combining labor, land, capital, and entrepreneurial ability, as in the four alternative techniques shown in the table below. Assume further that the firm can hire labor at $3 per unit, land at $3 per unit, capital at $6 per unit, and entrepreneurship at $9 per unit.

	Techniques			
	A	B	C	D
Labor	4	10	6	5
Land	5	3	3	3
Capital	5	2	4	4
Entrepreneurship	1	1	1	1

Refer to the provided table. If the price of labor declines from $3 to $2 per unit, then what is the least costly way of producing Zenias?

A. A
B. B
C. C
D. D

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Test Bank: II
Topic: Five Fundamental Questions

182.

The following table illustrates alternative production techniques for producing 18 widgets that can be sold for $1 each, for a total revenue of $18.

Resource	Price Per Unit of resource	Techniques (# of Units of Each resource Required)			
		A	B	C	D
Labor	$2	3	2	1	2
Land	1	2	1	3	1
Capital	4	1	2	2	3
Entrepreneurship	3	1	2	1	1

Based on the data given in the table, the most economically efficient production technique is

A. A.
B. B.
C. C.
D. D.

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Test Bank: II
Topic: Five Fundamental Questions

183.

The following table illustrates alternative production techniques for producing 18 widgets that can be sold for $1 each for a total revenue of $18.

Resource	Price Per Unit of resource	Techniques (# of Units of Each resource Required)			
		A	B	C	D
Labor	$2	3	2	1	2
Land	1	2	1	3	1
Capital	4	1	2	2	3
Entrepreneurship	3	1	2	1	1

Using technique A will result in an

A. economic loss of $2.
B. economic profit of $1.
C. economic profit of $2.
D. economic profit of $3.

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Test Bank: II
Topic: Five Fundamental Questions

184.

The following table illustrates alternative production techniques for producing 18 widgets that can be sold for $1 each for a total revenue of $18.

Resource	Price Per Unit of resource	Techniques (# of Units of Each resource Required)			
		A	B	C	D
Labor	$2	3	2	1	2
Land	1	2	1	3	1
Capital	4	1	2	2	3
Entrepreneurship	3	1	2	1	1

If the price per unit of labor were to increase from $2 to $3, the most efficient production technique would then be

A. A.

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B. B.
C. C.
D. D.

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Test Bank: II
Topic: Five Fundamental Questions

185. The following table illustrates alternative production techniques for producing 18 widgets that can be sold for $1 each for a total revenue of $18.

Resource	Price Per Unit of resource	Techniques (# of Units of Each resource Required)			
		A	B	C	D
Labor	$2	3	2	1	2
Land	1	2	1	3	1
Capital	4	1	2	2	3
Entrepreneurship	3	1	2	1	1

If the price of labor increases from $2 to $3, then the results of using Technique C will change from an economic

A. loss of $2 to a loss of $1.
B. profit of $2 to a profit of $1.
C. profit of $1 to a profit of $2.
D. loss of $1 to a loss of $2.

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Test Bank: II
Topic: Five Fundamental Questions

186. In a market system, the distribution of goods and services among consumers is largely determined by

A. the willingness and ability of consumers to pay the prices.
B. whoever needs the goods and services the most.
C. whoever has the closest connection to firms and the government.
D. a random factor that is almost impossible to predict.

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Test Bank: II
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187. "For whom is a given mix of goods and services to be produced? How, in other words, are the society's outputs to be distributed among its members?" In a market economy, this question is resolved primarily in the

A. public sector through the mechanism of central planning.
B. business sector through the mechanism of advertising.
C. private sector through the earning and spending of income.
D. money market through borrowing and saving by households and businesses.

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Test Bank: II
Topic: Five Fundamental Questions

188. The distribution of income in a market system is a primary factor that resolves which of the following fundamental economic questions?

A. What will be produced?
B. How will the output be produced?
C. How will the system accommodate change?
D. Who will get the output?

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Test Bank: II
Topic: Five Fundamental Questions

189. In a market economy, the incomes of consumers depend primarily upon

A. government policies in setting wages and interest rates.
B. the quantity and prices of resources that they possess.
C. the amount of savings that they have accumulated.
D. how closely connected they are to government and business leaders.

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Test Bank: II
Topic: Five Fundamental Questions

190. If economic profits in a particular industry increase, then we would expect

A. resources to be diverted away from that industry.
B. firms in that industry to produce less output.
C. firms to enter that industry, thus expanding it.
D. consumers to buy less from that industry.

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Difficulty: 02 Medium
Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: II
Topic: The Invisible Hand

191. In a market system, resources will move away from an industry when

A. profits of firms in the industry are rising.
B. demand for the industry's product is decreasing.
C. the production of output in the industry is rising.
D. profits of firms in other industries are falling.

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Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: II
Topic: The Invisible Hand

192. "Creative destruction" in a market system is brought about by

A. entrepreneurship.
B. striking workers.
C. regulation by the government.
D. money-based trade.

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Test Bank: II
Topic: The Invisible Hand

193. An increase in the demand for a product and a reduction in its costs of production would

A. decrease the profits of producers.
B. encourage firms to leave an industry.
C. encourage firms to enter an industry.
D. cause a shortage of the product.

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Test Bank: II
Topic: The Invisible Hand

194. In a market system, as one industry expands while another contracts, resources will flow

A. away from the expanding industry toward the contracting one.
B. across industries, driven by the changes in resource prices paid by firms.
C. toward the industry where the product demand is declining.
D. because resource allocation will have to equalize between the two industries.

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Test Bank: II
Topic: The Invisible Hand

195. The market system communicates changes in market conditions and elicits appropriate responses from businesses and resource suppliers through changes in prices. This is known as the

A. guiding function of prices.
B. monetary function of prices.
C. circular flow of income.
D. market determination of prices.

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Topic: The Invisible Hand

196. The development of the digital video camera, which replaced film video cameras, is an example of

A. roundabout production.
B. derived demand.
C. creative destruction.
D. specialization.

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Test Bank: II
Topic: The Invisible Hand

197. Which of the following does *not* illustrate the idea of *creative destruction*?

A. Digital downloads have shrunk the market for CDs and DVDs.
B. Online retail sales have increased, while brick-and-mortar sales have slowed down.
C. The opening of a new mall reduces the traffic in another mall.
D. A firm has to destroy some of the expired products in its inventory.

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Test Bank: II
Topic: The Invisible Hand

198. The idea that the desires of resource suppliers and firms to further their own self-interest will automatically further the public interest is known as

A. consumer sovereignty.
B. the invisible hand.
C. derived demand.
D. creative destruction.

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Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: II
Topic: The Invisible Hand

199. Which of the following best describes the "invisible hand" concept?

A. Ample regulation of business by the government will maximize the public's best interests.
B. The market system works best when resources are free to move from one use to another.
C. The problem of scarcity can best be overcome in a system of mixed capitalism.
D. Self-interest in a market system will automatically promote the public interest as well.

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200. The highly influential book by Adam Smith, who brought up the "invisible hand" notion, is titled

A. *Freakonomics.*
B. *The Principles of Economics.*
C. *The Age of the Economist.*
D. *The Wealth of Nations.*

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Test Bank: II
Topic: The Invisible Hand

201. The "invisible hand" concept refers to the

A. guiding function of prices in a market system.
B. implicit influence that the government has on the actions of firms.
C. regulatory structure that markets must operate in.
D. underlying money flows that promote the trading of goods and services.

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Test Bank: II
Topic: The Invisible Hand

202. Businesses seeking higher profits and resource suppliers seeking higher incomes lead to changes in the allocation of resources among different firms and end up with

A. consumers at the losing end.
B. output that society wants.
C. unnecessary conflict and turmoil.
D. a need for government action.

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Test Bank: II
Topic: The Invisible Hand

203. The major virtues of the market system include all of the following, *except*

A. it promotes an efficient allocation of resources.
B. it leads to equality in the distribution of income.
C. it provides incentives for greater production and higher incomes.
D. it emphasizes the freedom to pursue self-interest.

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Test Bank: II
Topic: The Invisible Hand

204. The market economy is regarded as "efficient" in that

A. it achieves the lowest rate of unemployment.
B. it leads to the lowest level of poverty in the society.
C. it directs resources toward products that the society wants most.
D. it puts the best people in government positions.

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Test Bank: II
Topic: The Invisible Hand

205. One basic problem faced by central planners, but hardly present in a market system, has to do with

A. determining the production goals or targets in a factory.
B. having limited resources and trying to match them with unlimited wants.
C. coordinating production in various industries so that bottlenecks do not develop.
D. providing financial resources for increasing the real flows of products in the economy.

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Difficulty: 02 Medium
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Test Bank: II
Topic: Economic Systems

206. The major "success indicator" for business managers in command economies like the Soviet Union and China *in the past* was

A. the quantity or volume of production.
B. product quality and variety.
C. the amount of profits a producer makes.
D. morale of workers in a firm.

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Blooms: Understand
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Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: II
Topic: Economic Systems

207. A characteristic of centrally planned economies is that

A. the price is relatively unimportant in allocating resources.
B. profits are the main measure of success of a firm.
C. entrepreneurship is quite prevalent and highly rewarded.
D. there are many incentives for innovation and hard work.

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Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: II
Topic: Economic Systems

208. Which of the following is true of an economy that operates entirely through central planning?

A. An individual's success in business is based on political savvy rather than economic profitability.

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B. There is relative ease in matching resource allocation to consumer demand by the central planners.
C. Central planners receive market information and coordinate economic activity through the price mechanism.
D. The system adapts easily to technological change, because there is a healthy entrepreneurial spirit.

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Blooms: Understand
Difficulty: 02 Medium
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TestBank: II
Topic: Economic Systems

209. In a command economy like the old Soviet Union, one is able to improve one's lot and get ahead in society largely through

A. entrepreneurship and risk-taking.
B. innovation and profits.
C. participating in the political hierarchy.
D. getting high prices for one's products and resources.

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Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: II
Topic: Economic Systems

210. According to economist Donald Boudreaux in the "Last Word" section of the chapter, what best explains why the market system is *not* a random, chaotic mess?

A. There is active cooperation among private property owners and government officials to correct the excesses of a market economy.
B. The roundabout methods of production allocate resources from consumers to producers in an orderly fashion.
C. Government planning limits the chaos, and the government regulates economic activity to create stability in the market.
D. Private property rights encourage mutual accommodation that leads to an arrangement of resources that is productive.

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Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-06 Explain how the market system deals with risk.
Test Bank: II
Topic: Five Fundamental Questions

211. In the circular flow model of the market system, households' major role is to

A. buy both products and resources.
B. sell both products and resources.
C. buy products and sell resources.
D. sell products and buy resources.

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Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: II
Topic: The Circular Flow Model

212. In the circular flow model of the market system, business firms' major role is to

A. buy products and resources.
B. sell products and resources.
C. buy products and sell resources.
D. sell products and buy resources.

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Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: II
Topic: The Circular Flow Model

213. The circular flow model illustrates

A. the importance of having a central plan for the economy.
B. how capital and other resources are created.
C. how money is created by the banking system.
D. the interdependence of businesses and consumers.

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Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: II
Topic: The Circular Flow Model

214. The simple circular flow model shows that workers and capital owners offer their services to firms through the

A. product markets.
B. resource markets.
C. money markets.
D. financial markets.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: II
Topic: The Circular Flow Model

215. In the circular flow model, households earn their incomes in the

A. resource markets.
B. product markets.
C. capitalist markets.
D. money markets.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: II
Topic: The Circular Flow Model

216. According to the circular flow model, product markets are where

A. households earn their money incomes.
B. households acquire economic resources from businesses.
C. businesses acquire their inputs from households.
D. businesses earn their revenues from households.

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Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: II
Topic: The Circular Flow Model

217. The money income of households consists of all the following, *except*

A. wages.
B. profits.
C. interest.
D. revenues.

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Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: II
Topic: The Circular Flow Model

218. Which of the following would be primarily determined in the resource markets?

A. the airfares charged by airlines for family vacations
B. the wage rates for computer programmers and engineers
C. the number of home-Internet connections installed
D. the amount of money in circulation issued by the government

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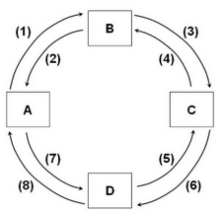
Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: II
Topic: The Circular Flow Model

219.

Refer to the provided figure. If box A represents households, B the product market, and C businesses, and if flow (3) represents revenues, then flow (1) would represent



A. costs.
B. money income.
C. consumption expenditures.
D. resources.

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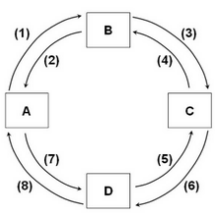
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: II
Topic: The Circular Flow Model

220.

Refer to the provided figure. If box A represents households, D the resource market, and C businesses, then flow (8) would represent , while flow (7) would represent _.



A. goods and services; consumption expenditures
B. consumption expenditures; goods and services
C. resources; money income
D. money income; resources

AACSB: Knowledge Application
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: II
Topic: The Circular Flow Model

221.

Refer to the provided figure. If box A represents households, B the product market, and C businesses, then flow (2) and flow (4) would represent

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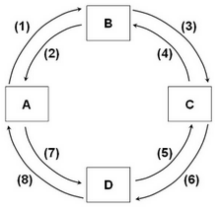

A. the flow of labor and other resources.
B. the flow of goods and services.
C. business spending revenues
D. money incomes and consumer spending.

AACSB: Knowledge Application
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: II
Topic: The Circular Flow Model

222. Which of the following is not a major category of business structure?

A. sole proprietorship
B. partnership
C. public agency
D. corporation

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: II
Topic: The Circular Flow Model

223. In the circular flow diagram, households get their ability to pay for their consumption expenditures from the

A. revenues they receive for their products.
B. costs they incur for resources.
C. incomes they earn for their resources.
D. goods and services they get in the product markets.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: II
Topic: The Circular Flow Model

224. In the circular flow diagram, firms get their ability to pay for the costs of production from the

A. revenues they receive for their products.
B. resources they acquire in the resource markets.
C. incomes they earn for their resources.
D. goods and services they get in the product markets.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: II
Topic: The Circular Flow Model

225. In a market system, the task of assessing and managing the business risk of a firm is taken on by the firm's

A. labor.
B. capital suppliers.
C. entrepreneurs.
D. customers.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-06 Explain how the market system deals with risk.
Test Bank: II
Topic: How the Market System Deals with Risk

226. Which of the following guides sensible decisions regarding the management of business risk in a market system?

A. the profit and loss system
B. the "invisible hand"
C. taxes and subsidies
D. consumer sovereignty

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-06 Explain how the market system deals with risk.
Test Bank: II
Topic: How the Market System Deals with Risk

227. In a market system, a firm's employees are typically shielded from business risk by

A. profit-sharing agreements.
B. wage contracts.
C. the Social Security program.
D. paid vacation leaves.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-06 Explain how the market system deals with risk.
Test Bank: II
Topic: How the Market System Deals with Risk

228. One essential trade-off involving business risk in a market system is reflected in which of the following statements?

A. Access to the firm's profits and gains are open only to those who take on the business risk of the firm.
B. Those who receive guaranteed payments from the firm are also guaranteed a share of the firm's profits.

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C. Those who make bad decisions regarding risk will suffer losses; those who decide wisely will gain profits.
D. Those who bear the business risk of the firm are guaranteed to always gain profits.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-06 Explain how the market system deals with risk.
Test Bank: II
Topic: How the Market System Deals with Risk

229. In a market system, which of the following is a major benefit of making the firm's owners and investors exclusively shoulder the business risk?

A. Those who deeply dislike business risk will not have anything to do with the business.
B. This allows firms to more easily attract labor and other suppliers of inputs.
C. This reduces the business risk in the economy.
D. It makes it easier for the government to monitor and manage the business risk.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-06 Explain how the market system deals with risk.
Test Bank: II
Topic: How the Market System Deals with Risk

230. Insurance companies facilitate the transfer of risk from

A. those who have a low-risk tolerance to those with high risk-tolerance.
B. those who have a high-risk tolerance to those with low risk-tolerance.
C. the insurance companies' owners to the insurance policyholders.
D. insurance policyholders to the government.

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-06 Explain how the market system deals with risk.
Test Bank: II
Topic: How the Market System Deals with Risk

True / False Questions

231. A market system is characterized by the private ownership of resources and the use of prices to coordinate economic activity.

TRUE

AACSB: Analytical Thinking
Accessibility: Keyboard Navigation
Blooms: Analyze
Difficulty: 03 Hard
Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system.
Test Bank: II
Topic: Economic Systems

232. Most market economies, such as the U.S. and the U.K., allow government policies and actions aimed at promoting economic growth and stability.

TRUE

AACSB: Analytical Thinking
Accessibility: Keyboard Navigation
Blooms: Analyze
Difficulty: 03 Hard
Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system.
Test Bank: II
Topic: Economic Systems

233. In a command economy, the head of each household makes the fundamental economic choices such as what to produce and how to produce output.

FALSE

AACSB: Analytical Thinking
Accessibility: Keyboard Navigation
Blooms: Analyze
Difficulty: 03 Hard
Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system.
Test Bank: II
Topic: Economic Systems

234. The economy of the United States in the past can best be described as *laissez-faire* capitalism.

FALSE

AACSB: Analytical Thinking
Accessibility: Keyboard Navigation
Blooms: Analyze
Difficulty: 03 Hard
Learning Objective: 02-01 Differentiate between laissez-faire capitalism, the command system, and the market system.
Test Bank: II
Topic: Economic Systems

235. Property rights give to some people the right to coerce others into giving up their property.

FALSE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

236. Property rights give the government the right to own, use, and dispose of resources in an economy.

FALSE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

237. Selfishness and self-interest are identical concepts in economics.

FALSE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II

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Topic: Characteristics of the Market System

238. An important aspect of the market system is that producers and consumers always have to consider the public interest in making production and consumption decisions.

FALSE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

239. If people tried to produce most of what they need on their own, then this would lead to a more efficient use of the economy's resources.

FALSE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

240. Being a "jack-of-all-trades" implies reducing the reliance on the division of labor.

TRUE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

241. Even with the use of money, exchange and trade cannot occur if there is no coincidence of wants.

FALSE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

242. One of the most important economic resources is money.

FALSE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 01 Easy
Learning Objective: 02-02 List the main characteristics of the market system.
Test Bank: II
Topic: Characteristics of the Market System

243. In a market system, the distribution of goods and services largely depends on the distribution of income and people's preferences.

TRUE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: II
Topic: Five Fundamental Questions

244. The fundamental economic question regarding the distribution of output in the economy is equivalent to the question of who will produce the output.

FALSE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: II
Topic: Five Fundamental Questions

245. The concept of consumer sovereignty refers to the situation where consumers have the right to vote for the board of directors of large corporations.

FALSE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: II
Topic: Five Fundamental Questions

246. In analyzing a market system, economists often assume that firms will choose the production techniques that will give them the maximum revenues.

FALSE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: II
Topic: Five Fundamental Questions

247. Economic efficiency entails producing a certain output with the minimum number of units of inputs.

FALSE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: II
Topic: Five Fundamental Questions

248. The choice of the most efficient production technique is not affected by how much buyers want to buy the product.

TRUE

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AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: II
Topic: Five Fundamental Questions

249. Even if prices are fixed and competition is restricted by the government, the invisible hand will still work in the economy and lead to economic efficiency.

FALSE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: II
Topic: The Invisible Hand

250. In a market system, a consumer's ability to pay—but *not* necessarily his willingness to pay—is largely based on his income.

TRUE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-03 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote progress.
Test Bank: II
Topic: Five Fundamental Questions

251. In a competitive market economy, firms and resource suppliers seeking to further their own self-interest will end up, as though guided by an invisible hand, promoting the public interest.

TRUE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: II
Topic: The Invisible Hand

252. The problems of central planning become less complex as an economy grows in size over time.

FALSE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: II

253. Profits are the primary "success indicator" for firms in a centrally planned economy.

FALSE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: II

254. Quantitative measures of managerial success, such as production targets or quotas, are highly foolproof and are thus ideal to use in raising economic efficiency.

FALSE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-04 Explain the operation of the invisible hand and why market economies usually do a better job than command economies at efficiently transforming economic resources into desirable output.
Test Bank: II

255. In the circular flow model, households act as buyers in the resource markets.

FALSE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: II
Topic: The Circular Flow Model

256. In a market system, entrepreneurs start businesses in order to earn a high salary.

FALSE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: II
Topic: The Circular Flow Model

257. In a market system, the income earned by owners of natural resources is called interest income.

FALSE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: II
Topic: The Circular Flow Model

258. A corporation is a type of business firm where the debt of the firm is considered its owners' personal responsibility.

FALSE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: II
Topic: The Circular Flow Model

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259. According to the circular flow model of the market system, firms get their ability to pay for their costs of production from the revenues that they receive for their products.

TRUE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: II
Topic: The Circular Flow Model

260. According to the circular flow model of the market system, when resource-owners' money income is rising, then the costs to business firms that employ their resources must be falling.

FALSE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-05 Describe the mechanics of the circular flow model.
Test Bank: II
Topic: The Circular Flow Model

261. Having a high fixed salary is what motivates entrepreneurs to make prudent decisions is dealing with business risk.

FALSE

262. Government bailouts of failing businesses, like banks during the recent economic crisis, will tend to reduce the motivation among entrepreneurs to make prudent decisions is dealing with business risk.

TRUE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-06 Explain how the market system deals with risk.
Test Bank: II
Topic: How the Market System Deals with Risk

263. College graduates who dislike business risk will mostly seek to be hired by firms as labor, rather than starting their own firms as entrepreneurs.

TRUE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-06 Explain how the market system deals with risk.
TestBank: II
Topic: How the Market System Deals with Risk

264. When somebody buys an insurance policy, that person is seeking to transfer risk away from herself and pass it on to the insurance company.

TRUE

AACSB: Knowledge Application
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 02 Medium
Learning Objective: 02-06 Explain how the market system deals with risk.
Test Bank: II
Topic: How the Market System Deals with Risk

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CHAPTER **2**

The Market System and the Circular Flow

A. Short-Answer, Essays, and Problems

1. Define the term economic system. Discuss the two ways in which economic systems can differ.

2. Explain the term "laissez faire capitalism."

3. Explain what is meant by a command economy.

4. Evaluate the statement: "The government should have no place in a capitalistic market system."

5. List nine characteristics of the market system.

6. Why is the right of private property an essential characteristic of a market system?

7. What role does freedom play in capitalism? How important is it to the operation of a competitive market economy?

8. Explain the importance of self-interest in the operation of a market system.

9. What is the importance of competition in relation to self-interest in a market system?

10. What conditions are necessary for economic competition to exist?

11. "The regulatory force in the market system bears the seeds of its own destruction." Explain and evaluate.

12. Explain why the market system is an organizing mechanism.

13. Respond to the following question: "Producing capital goods or advanced technology takes time, so how can that be a more efficient form of production of consumer goods?"

14. Describe two types of specialization in production.

15. What are the economic advantages of specialization?

16. Describe three ways that human specialization contributes to society's output.

17. What advantage does a money economy have over a barter economy?

18. How does the use of money differ from the use of barter in the exchange of goods and services?

19. What is money and what important function does it perform? Explain how it overcomes the disadvantages associated with barter. What conditions are necessary for people to accept paper currency in exchange for the goods and services which they sell?

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20. Suppose Tom, Dick, and Harry live in a barter economy. Tom produces wine, Dick bakes bread, and Harry makes cheese. Tom wants some bread to go with his wine and is willing to trade 1 gallon of wine for two loaves of bread. Dick wants some cheese to go with his bread and is willing to trade one loaf of bread for one-half pound of cheese. Harry doesn't want bread, but wants some wine to go with his cheese and is willing to trade cheese for one gallon of wine. It is not possible for all three to meet together at one time.

    (a) Explain how this situation illustrates the difficulty with a barter economy.
    (b) Devise a money system using precious stones where four stones are equivalent in value to one gallon of wine. In other words tell how much bread and cheese would be worth in terms of stones in this economy. In this system, how much cheese must Harry sell in order to buy one gallon of wine?

21. What are the so-called Five Fundamental Questions that every economy must answer?

22. A firm has the choice between producing product A, B, or C. In producing the products the firm faces a weekly cost of $10 for product A, $130 for product B and $200 for product C. The prices received for each product at different quantities are listed in the table below.

Output	Product A	Product B	Product C	Profit A	Profit B	Profit C
5	$3.00	$15.00	$35.00	_____	_____	_____
10	2.00	12.00	20.00	_____	_____	_____
15	1.25	9.00	10.00	_____	_____	_____

    (a) Compute the firm's profit for A, B, and C and enter this data into the table.
    (b) Which product will the firm choose to produce and how much output will maximize profit?

23. Assume that a firm can produce product A, product B, or product C with the resources it currently employs. These resources cost the firm a total of $100 per week. Assume, for the purposes of this problem, that the firm's costs cannot be changed. The market prices and the quantities of A, B, and C these resources can produce are given as follows.

Product	Market price	Output	Profit
A	$14.00	10	$_____
B	9.00	11	_____
C	.50	300	_____

    (a) Compute the firm's profit when it produces A, B, or C and enter these data in the table.
    (b) Which product will the firm produce?
    (c) If the price of A rose to $16, which product will the firm produce?
    (d) If the firm produces A at a price of $16, what would tend to happen to the number of firms producing product A?

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24. Assume that a firm can produce product A, product B, or product C with the resources it currently employs. These resources cost the firm a total of $100 per week. Assume, for the purposes of this problem, that the firm's costs cannot be changed. The market prices and the quantities of A, B, and C these resources can produce are given below.

Product	Market price	Output	Profit
A	$10.00	6	$_____
B	5.00	19	_____
C	1.50	100	_____

(a) Compute the firm's profit when it produces A, B, or C and enter these data in the table.
(b) Which product will the firm produce?
(c) Suppose the quantity of product B the firm was able to produce with the same amount of inputs now rose to 25. Which product will the firm now produce?
(d) As a result of the rise in quantity of product B to 25 that each firm can produce, what will happen to the number of firms producing product B?

25. How does 'consumer sovereignty' determine the types and quantities of the goods produced in an economy?

26. How does consumer choice differ from consumer sovereignty in a market system?

27. Explain in detail how a decrease in consumer demand for a product will result in less of the product being produced and in fewer resources being allocated to its production.

28. (Consider This) How is consumer sovereignty at work at McDonalds? Give an example of a hit and a miss.

29. The demand for a resource is "derived" from the goods and services that the resource is used to produce. Give three examples.

30. Why does competition force firms to use the least-cost, most efficient, productive techniques?

31. Assume that a firm finds that its profits will be maximized (or losses minimized) when it produces $30 worth of product X. Each of these techniques shown in the following table will produce exactly $30 worth of X.

	Unit resource prices	Method #1	Method #2	Method #3
Land	$1	6	3	4
Labor	2	4	3	3
Capital	3	3	4	6
Entrepreneurship	4	2	4	1

(a) Which method is most efficient? Why?
(b) Given the above prices, will the firm adopt a new method which involves 10 units of land, 3 of labor, 2 of capital, and 2 of entrepreneurial ability?
(c) Suppose the price of capital falls to $1 without any other prices changing. Which of the methods will the firm now choose? Why?

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32. Assume that a firm finds that its profits will be maximized (or losses minimized) when it produces $50 worth of product X. Each of these techniques shown in the following table will produce exactly $50 worth of X.

	Unit resource prices	Method #1	Method #2	Method #3
Land	$4	4	2	1
Labor	3	4	3	6
Capital	2	3	4	3
Entrepreneurship	1	3	6	4

(a) Which method is most efficient? Why?
(b) Given the above prices, will the firm adopt a new method which involves 2 units of land, 2 of labor, 4 of capital, and 8 of entrepreneurial ability?
(c) Suppose the price of labor falls to $1 without any other prices changing. Which of the methods will the firm now choose? Why?

33. What is meant by the guiding function of prices?

34. How can technological advance result in creative destruction?

35. Adam Smith in his 1776 book the *Wealth of Nations* describes the concept of "an invisible hand." Explain what he means by an "invisible hand."

36. Explain this quote from Adam Smith: "It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner but from their regard to their own interest."

37. "Competition is the mechanism that brings order out of potential chaos in a price-directed economy." Explain.

38.Describe the three major virtues of a market system.

39. What are the two main problems that have caused the demise of the command systems?

40. What is the coordination problem in command economics?

41. Is the problem of coordination common to all economies? Explain how the problem is met in a market economy and how coordination was dealt with in a command economy.

42. What is the incentive problem in central planning?

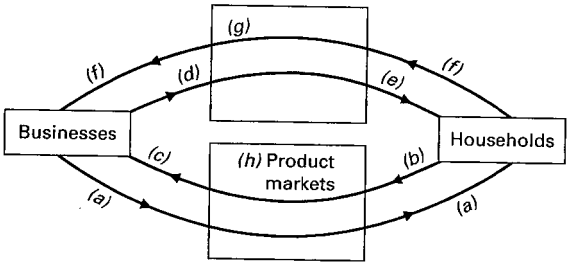
43. "A major reason the economy of the former Soviet Union collapsed was due to a lack of incentives that are provided by the profit system." Evaluate.

44. (Consider This) Explain the differences in economic systems between North and South Korea and the economic outcomes of the two systems.

45. Describe the basic features of the circular flow diagram.

46. What is the relationship between businesses and households in the circular flow diagram?

47. In the below circular flow diagram, the household and business sectors are labeled with arrows representing



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the flows of income and output labeled (a) through (f) and the two appropriate markets labeled (g) and (h). Supply the correct descriptive titles for each of these labels (a) through (h).

48. Describe the flows that occur between (a) households and the product market, (b) businesses and the product market, and (c) households and the resource market.

49. In which market would each of the following be determined?
(a) The wage of a lawyer.
(b) The quantity of electric cars produced.
(c) The price of a new television.
(d) The quantity of farm land used to produce corn.

50. Define the three main categories of businesses.

51. Explain the main characteristics of a corporation.

52. In a market system entrepreneurs or the managers they hire must deal with risk. Discuss the incentives of these individuals when dealing with risk, relative to those of a central planner in a command economy.

53. Describe how business risk affects employees.

54. Discuss the benefits of restricting business risk to owners and investors.

55. Who is the residual claimant of a firm? How are they effected by the firm declaring a profit or loss?

56. (Consider This) How does the market for insurance promote economy growth and investment?

57. (Last Word) Explain why the arrangement in the use of resources in a market system is not random given the decentralized nature of the system.

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B. Answers to Short-Answer, Essays, and Problems

1. Define the term economic system. Discuss the two ways in which economic systems can differ.

   An economic system is the set of institutional arrangements and coordinating mechanism for solving society's economic problem (a method of organizing an economy). Systems differ based on how the answer (1) who owns the factors of production and (2) the method used to motivate, coordinate, and direct economic activity.

2. Explain the term "laissez faire capitalism."

   Pure capitalism is sometimes called "laissez faire" capitalism which is a French term for "let it be." In pure capitalism the government's role is limited to protecting private property and establishing the legal framework for free enterprise and free markets to function.

3. Explain what is meant by a command economy.

   The command economy is the opposite extreme alternative to laissez-faire capitalism. It is a system characterized by government ownership of all or nearly all property resources and centrally planned and administered production.

4. Evaluate the statement: "The government should have no place in a capitalistic market system."

   While having a large government presence in the economy like in a command market system can be detrimental to efficiency, innovation and growth, there is still a place for government in a capitalistic system. Government can work to promote economic stability and growth and provide rules for the market system to ensure fair business practices, all of which benefit the economy and society as a whole. The government can also work to provide goods and services that would be underproduced or not produced at all. The government also redistributes income. While market forces play the dominant role in determining what and how much is produced, the government still has a part in the system.

5. List nine characteristics of the market system.

   The six characteristics discussed in the text are: (1) private property; (2) freedom of enterprise and choice; (3) self-interest as the major motivation for economic activity; (4) competition among buyers and sellers; (5) reliance on the market (price) system; (6) the use of advanced technology and large amounts of capital goods; (7) specialization; (8) the use of money rather than barter; and (9) a limited role for government.

6. Why is the right of private property an essential characteristic of a market system?

   Property rights are important because they give people private ownership of resources. This ownership encourages them to make the best use of those resources because they will benefit if they do. Property rights also encourage people to take the risk of investing in capital goods or to develop new innovation or products because they will receive the benefits from this activity if they are successful. Property rights offer incentives for people to maintain their property to preserve its value and invest in it if they think they can increase its value. Property rights also facilitate exchanges by making clear who owns a resource so that there is no question about the legitimacy of the transaction.

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7. What role does freedom play in capitalism? How important is it to the operation of a competitive market economy?

   In capitalism, two essential freedoms are the freedom of enterprise and freedom of choice. Business must be free to get economic resources, organize them to produce products, and sell them in the market. Businesses must also be free to enter or leave an industry. Freedom of choice gives business owners, resource owners, and consumers' freedom to act to advance their own self-interest. Business owners are free to buy and sell property. Labor resources (workers) can enter or exit any line of work for which they are qualified. Consumers are free to purchase goods and services as they choose based on their budget constraints. Without these freedoms it would be impossible for a market economy to exist.

8. Explain the importance of self-interest in the operation of a market system.

   Self-interest is the motivating force behind both the demand and supply sides of the product and resource markets in a capitalist system. Entrepreneurs engage in production with the expectation of making a profit; workers seek the best wage and working conditions they can get; consumers allocate their spending in order to maximize their satisfaction.

9. What is the importance of competition in relation to self-interest in a market system?

   Competition is important as the force which tempers or regulates the greed or self-interest of the producers, sellers, workers, and buyers. If producers make too much profit, competitors will arise to take advantage of the opportunity and as production increases, prices and profits will fall. If workers demand too much, employers will seek other workers who are willing to work for less. If buyers are not willing to pay a fair price for the product, producers will sell the product to someone who is. In each case it is competition or the threat of competition that tempers the greed of the economic "player."

10. What conditions are necessary for economic competition to exist?

    Competition requires the presence of large numbers of buyers and sellers. The number must be large enough so that no single buyer or seller can affect the price of the product by their individual actions regarding demand or supply. In addition, competition assumes that it is simple for producers to enter or leave a particular industry so that the economy can adjust appropriately to changes in consumer demand, technology, or resource supplies.

11. "The regulatory force in the market system bears the seeds of its own destruction." Explain and evaluate.

    Competition is the regulatory mechanism of the market economy. However, a successful competitor has the potential of driving rivals out of business if the most successful firm is more efficient and other firms are either purchased or leave the industry unable to compete with the most successful. If this occurs, there is the potential of just a few successful firms remaining in the industry, and the competition that once existed has been reduced or even ultimately destroyed as the most successful firms gain monopoly power.

    In other words, competitive firms want to "beat" their rivals, but if they are successful in damaging their competitors, they would also destroy competition.

12. Explain why the market system is an organizing mechanism.

    Markets and price give the economic system its ability to coordinate millions of economics decisions made on a daily basis. The system is an extensive communication network for expressing the wishes of consumers to producers. The price signals given by markets direct resources to the goods and services people want and indicate where profits are to be made for producers. Producers who fail to heed the market signals are punished. Consumers also use the market price to figure out how to make the best use of their limited incomes.

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13. Respond to the following question: "Producing capital goods or advanced technology takes time, so how can that be a more efficient form of production of consumer goods?"

    The production of capital goods or advanced technology does require time. These capital goods, however, can then be used to increase the production of consumer goods. This roundabout method of production is more efficient over time, but it does not come without a cost. As shown by the production possibilities curve, resources used to make capital goods must be diverted from the production of consumer goods today to produce capital goods that will then be used to increase the consumer goods of tomorrow.

14. Describe two types of specialization in production.

    Specialization may be of the human form with division of labor where different workers perform different production tasks; or it may be geographic specialization where some goods and services are produced in certain regions and others are produced in other areas.

15. What are the economic advantages of specialization?

    The advantages come from increased productivity or output per worker as specialized workers gain skills in performing one task. Therefore, more is produced with the same amount of resources as before specialization.

16. Describe three ways that human specialization contributes to society's output.

    First, specialization lets people take advantage of differences in skills and abilities so they can be more efficient and productive. Second, specialization fosters learning by doing so people can become good at a particular task. Third, specialization saves time because people do not have to switch from one task to another.

17. What advantage does a money economy have over a barter economy?

    Trade is difficult with barter because it requires a coincidence of wants. Money overcomes that problem. A buyer can obtain goods without having to locate a seller who desires what the person has to trade. All products can be priced and traded on a common basis. Also, with money, neither party needs to carry products around with them so they are always available for trade. Money facilitates the exchange of products which is necessary for specialization. Economic efficiency is improved with a system of money.

18. How does the use of money differ from the use of barter in the exchange of goods and services?

    Barter requires a coincidence of wants in order for exchange to take place both parties have to want what the other is offering. Money, on the other hand, acts as a medium of exchange in that the appropriate quantity of it is generally acceptable in exchange for any good or service.

19. What is money and what important function does it perform? Explain how it overcomes the disadvantages associated with barter. What conditions are necessary for people to accept paper currency in exchange for the goods and services which they sell?

    Money is anything that is generally acceptable as a medium of exchange. In the United States economy, money includes currency, coins, and checkable deposits.

    Barter requires a coincidence of wants between the two parties to a transaction. Each has to want what the other has to offer. Money makes this coincidence unnecessary, as the seller is willing to accept money in exchange for goods or services offered and can, in turn, exchange the money earned for other goods and services from another seller. The necessary condition for the use of paper currency is that it must be generally acceptable. Sellers must have faith that the currency will have value when they want to use it to buy goods and services for themselves.

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Note that the money does not have to have any intrinsic value; that is, it does not have to be backed by a material that has some use like gold or silver.

20. Suppose Tom, Dick, and Harry live in a barter economy. Tom produces wine, Dick bakes bread, and Harry makes cheese. Tom wants some bread to go with his wine and is willing to trade 1 gallon of wine for two loaves of bread. Dick wants some cheese to go with his bread and is willing to trade one loaf of bread for one-half pound of cheese. Harry doesn't want bread, but wants some wine to go with his cheese and is willing to trade cheese for one gallon of wine. It is not possible for all three to meet together at one time.

    (a) Explain how this situation illustrates the difficulty with a barter economy.
    (b) Devise a money system using precious stones where four stones are equivalent in value to one gallon of wine. In other words tell how much bread and cheese would be worth in terms of stones in this economy. In this system, how much cheese must Harry sell in order to buy one gallon of wine?

    (a) The lack of coincidence of wants is illustrated in this situation. Tom wants the bread that Dick has, Dick wants Harry's cheese, and Harry wants Tom's wine but for any two of them there is no incentive to trade for something each does not want. In other words, there is no coincidence of wants.
    (b) If precious stones could be used as a medium of exchange, Tom could receive four stones for each gallon of wine. According to their initial exchange values, he should be willing to pay two stones for each loaf of bread. Dick would then have four stones to purchase one pound of cheese and Harry could buy wine with the four stones he earned from selling this cheese. In terms of stone prices, bread is worth two stones per loaf and one gallon of wine and one pound of cheese are each worth four stones in this economy.

21. What are the so-called Five Fundamental Questions that every economy must answer?

    Every economy must respond to five fundamental economic questions. What goods and services will be produced? How will the goods and services be produced? Who will get the goods and services? How will the system accommodate change? How will the system promote progress?

22. A firm has the choice between producing product A, B, or C. In producing the products the firm faces a weekly cost of $10 for product A, $130 for product B and $200 for product C. The prices received for each product at different quantities are listed in the table below.

Output	Product A	Product B	Product C	Profit A	Profit B	Profit C
5	$3.00	$15.00	$35.00	_____	_____	_____
10	2.00	12.00	20.00	_____	_____	_____
15	1.25	9.00	10.00	_____	_____	_____

    (a) Compute the firm's profit for A, B, and C and enter this data into the table.
    (b) Which product will the firm choose to produce and how much output will maximize profit?

    (a) *See table.*

Output	Product A	Product B	Product C	Profit A	Profit B	Profit C
5	$3.00	$15.00	$35.00	$ 5.00	($55.00)	($25.00)
10	2.00	12.00	20.00	10.00	(10.00)	0
15	1.25	9.00	10.00	8.75	5.00	(50.00)

    (b) The firm will produce product A, because it produces the largest profit of $10 at 10 units of output.

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23. Assume that a firm can produce product A, product B, or product C with the resources it currently employs. These resources cost the firm a total of $100 per week. Assume, for the purposes of this problem, that the firm's costs cannot be changed. The market prices and the quantities of A, B, and C these resources can produce are given as follows.

Product	Market price	Output	Profit
A	$14.00	10	$_____
B	9.00	11	_____
C	.50	300	_____

(a) Compute the firm's profit when it produces A, B, or C and enter these data in the table.
(b) Which product will the firm produce?
(c) If the price of A rose to $16, which product will the firm produce?
(d) If the firm produces A at a price of $16, what would tend to happen to the number of firms producing product A?

Product	Market price	Output	Profit
A	$14.00	10	$40.00
B	9.00	11	− 1.00
C	.50	300	50.00

(a) Profit for A will be $40; for B will be −$1 (loss); for C will be $50.
(b) Firm will produce product C.
(c) If the price of A rises (assuming the firm can sell all of its output at the new price), it would make a profit of $60 on A and so would produce product A.
(d) If other firms face similar costs, more firms would enter industry A to take advantage of the higher economic profits.

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24. Assume that a firm can produce product A, product B, or product C with the resources it currently employs. These resources cost the firm a total of $100 per week. Assume, for the purposes of this problem, that the firm's costs cannot be changed. The market prices and the quantities of A, B, and C these resources can produce are given below.

Product	Market price	Output	Profit
A	$10.00	6	$_____
B	5.00	19	_____
C	1.50	100	_____

(a) Compute the firm's profit when it produces A, B, or C and enter these data in the table.
(b) Which product will the firm produce?
(c) Suppose the quantity of product B the firm was able to produce with the same amount of inputs now rose to 25. Which product will the firm now produce?
(d) As a result of the rise in quantity of product B to 25 that each firm can produce, what will happen to the number of firms producing product B?

Product	Market price	Output	Profit
A	$10.00	6	−$40.00
B	5.00	19	− 5.00
C	1.50	100	50.00

(a) Profit for A will be −$40 (loss); for B will be −$5 (loss); for C will be $50.
(b) The firm will produce product C.
(c) The firm would still choose product C.
(d) If all firms are identical with identical costs, there will be no change in the number of firms producing product B because it is still more profitable for each firm to product C. Thus product B is unaffected.

25. How does 'consumer sovereignty' determine the types and quantities of the goods produced in an economy?

Consumers make 'dollar votes' by purchasing what they are most willing and able to buy. The 'votes' register consumers' wants in the economy and if the demand is enough to produce an economic profit in an industry, then the economy will increase production of that good. Conversely, if the level of demand results in a loss in that industry, the economy will decrease production of that good. Businesses and resource suppliers are not completely free to produce the goods and services they wish, but rather must face the preferences of the consumers.

26. How does consumer choice differ from consumer sovereignty in a market system?

Consumer choice by itself refers only to consumers' freedom to choose what they are willing and able to buy from what is available. Consumer sovereignty that exists in a market system goes one crucial step further. It means that producers respond to the choices that consumers make. If consumer demand declines for a particular product, that decreased demand will be reflected in prices and quantity produced. If consumer demand increases, that also will be reflected in terms of prices and quantities produced. In a centrally planned system changing consumer demand is largely ignored in favor of planners' decisions which focus on the state's goals rather than consumer wishes.

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27. Explain in detail how a decrease in consumer demand for a product will result in less of the product being produced and in fewer resources being allocated to its production.

Given the supply schedule or supply curve, a decrease in consumer demand means less quantity demanded than was previously the case at each possible price. The demand curve shifts to the left.

Graphically, this will result in a new lower equilibrium quantity offered at a lower equilibrium price because consumers will not buy as much at the original equilibrium price. To eliminate a surplus at the old price, competing firms will lower the price until the quantity offered is just equal to the quantity demanded. This new quantity offered will not be as great as the original quantity. Because of less output, fewer resources will be needed.

28. (Consider This) How is consumer sovereignty at work at McDonalds? Give an example of a hit and a miss.

Consumer sovereignty determines what goods get produced in the market and at businesses. If consumers like a product, a company will find it profitable to produce and sell it (a hit). If consumers do not like a product, a company will find it unprofitable to produce and sell it (a miss). An example of a recent hit at McDonalds is the "McGriddle." An example of a recent miss is the "Fish McBites."

29. The demand for a resource is "derived" from the goods and services that the resource is used to produce. Give three examples.

There is a demand for lumber because there is a demand for furniture or a demand for houses. There is a demand for wheat because there is a demand for bread and other products made with wheat (or wheat flour). There is a demand for chemical workers because there is a demand for chemicals.

30. Why does competition force firms to use the least-cost, most efficient, productive techniques?

If firms do not use the most efficient techniques, their rivals who do use more efficient methods will be able to charge lower prices and potentially take buyers from the less efficient seller. If the less efficient firm has to lower prices to match the competition without improving efficiency, it will eventually realize losses and in the long term will have to leave the industry unless it, too, uses the most efficient production methods.

31. Assume that a firm finds that its profits will be maximized (or losses minimized) when it produces $30 worth of product X. Each of these techniques shown in the following table will produce exactly $30 worth of X.

	Unit resource prices	Method #1	Method #2	Method #3
Land	$1	6	3	4
Labor	2	4	3	3
Capital	3	3	4	6
Entrepreneurship	4	2	4	1

(a) Which method is most efficient? Why?
(b) Given the above prices, will the firm adopt a new method which involves 10 units of land, 3 of labor, 2 of capital, and 2 of entrepreneurial ability?
(c) Suppose the price of capital falls to $1 without any other prices changing. Which of the methods will the firm now choose? Why?

(a) Method #1 is most efficient because it uses relatively more of the least expensive resource, and relatively less of the more expensive resources.
(b) Yes, it is now the least-cost method.

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(c) It will choose #3 because it uses relatively more of capital which is now much less expensive and the total cost of each method now makes #3 the least-cost combination.

32. Assume that a firm finds that its profits will be maximized (or losses minimized) when it produces $50 worth of product X. Each of these techniques shown in the following table will produce exactly $50 worth of X.

	Unit resource prices	Method #1	Method #2	Method #3
Land	$4	4	2	1
Labor	3	4	3	6
Capital	2	3	4	3
Entrepreneurship	1	3	6	4

(a) Which method is most efficient? Why?
(b) Given the above prices, will the firm adopt a new method which involves 2 units of land, 2 of labor, 4 of capital, and 8 of entrepreneurial ability?
(c) Suppose the price of labor falls to $1 without any other prices changing. Which of the methods will the firm now choose? Why?

(a) Method #2 is most efficient because it uses relatively more of the least expensive resource, and relatively less of the more expensive resources.
(b) Yes, it is now the least-cost method.
(c) It will choose #3 because it uses relatively more of labor which is now much less expensive and the total cost of each method now makes #3 the least-cost combination.

33. What is meant by the guiding function of prices?

The guiding function of prices refers to the response of producers to changes in prices. With a given supply schedule, if demand increases, the market equilibrium price will rise and producers will respond to that by producing an increased quantity of the product. Also, there may be entry of firms into the industry. Conversely, if demand decreases, the market equilibrium price will fall and producers will respond to that change by producing a decreased quantity of the product. There may also be an exodus of firms from the industry. The market system is a communications system and prices are the way information is communicated and incentives are given to take action.

34. How can technological advance result in creative destruction?

Rival firms must follow the lead of innovative firms that are making economic profits. If the rival firms fail to do so, they can suffer economic losses and eventually fail or be bought by other firms. Sometimes technological advance actually destroys industries because an old product is no longer needed with a new innovation put on the market, a situation referred to as creative destruction. The innovation creates a new product, but in the process of doing so it effectively destroys an industry. One example would be the automobile which eventually destroyed the market for horse-drawn carriages.

35. Adam Smith in his 1776 book the *Wealth of Nations* describes the concept of "an invisible hand." Explain what he means by an "invisible hand."

Smith describes how businesses that operate to promote their own self-interest in the attempt to make a profit from providing a product for society also wind up promoting or advancing the public or social interest. Businesses provide products to the market that they hope consumers will want to buy. Consumers will benefit from having such products available. At the same time, businesses will try to produce those products at the least possible cost to try to maximize their profit, thus helping consumers obtain more goods

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and services per dollar spent. Through the competitive market, businesses direct resources to their highest and best use that benefits the businesses and society as if guided by an "invisible hand."

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36. Explain this quote from Adam Smith: "It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner but from their regard to their own interest."

    Adam Smith believed that sellers want to make a profit and that is the reason that they are willing to sell to consumers. They are not producing bread, beer, or meat to satisfy the hunger of their customers, but rather to earn the revenue that results from the sale of these products. If they produced due to benevolence, they would give away these products.

37. "Competition is the mechanism that brings order out of potential chaos in a price-directed economy." Explain.

    This is true in the absence of government direction of production. Producers are forced to produce at lowest cost by the pressures of competition. If they don't they will not be able to sell their goods and services, because their rivals will attract the buyers at lower prices. Furthermore, producers must produce what consumers want at prices which just cover their economic costs or other producers will attract the buyers away from them. Thus, producers are driven by competition in the most efficient manner in the sense of maximizing output and the most efficient manner in terms of maximizing society's satisfaction.

38. Describe the three major virtues of a market system.

    First, the market system promotes efficient use of scarce resources. Products are produced in the least costly way and the products most desired by society get produced. Second, the market system provides incentives for continual improvement and innovation. Rewards are given to entrepreneurs, workers, and consumers who attempt to make the best use of scarce resources. Third, the market system gives great support to individual freedom for producers, consumers, and workers. Each group is able to pursue their own self-interest and thus promote the social interest.

39. What are the two main problems that have caused the demise of the command systems?

    The first problem is that of coordination. In a planned economy, central planners have to coordinate millions of decisions made by consumers, producers and resource suppliers. This involved planning anything from production targets and resource allocation. This took a considerable amount of time and investment.

    These decisions, however, may not produce the intended results. For example, if one firm did not meet their production quota, this would have severe ramifications on the market price of the product, the production of industries that used the product in their production, and onward. These problems would only be magnified as the economy expanded, resulting in shortages, bottlenecks and production stoppages.

    Another piece of the coordination problem is that lack of a success indicator. In a command economy the major success indicator is the quantitative output, regardless of costs and quality considerations. Thus, production managers in many cases would sacrifice product quality to meet production goals.

    The second problem facing command economies is an incentive problem. Since central planners determined the output level, managers had no incentive to alter production. Persistent shortages or surpluses resulted because there weren't the necessary price indications to promote the increase or the halt of production of a certain product.

    Another incentive problem was the lack of entrepreneurs. In command economies, firms got rewarded for meeting quantity targets and engaging in political maneuvering. This system did not promote technological advance.

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40. What is the coordination problem in command economics?

The coordination problem involves the difficulty of coordinating the many inter-dependent segments of the economy and the avoidance of the chain reaction that would result from a bottleneck in any one of the segments. This coordination problem became even more difficult as the economy grew larger and more complex, and more economic decisions had to be made in the production process. There were also inadequate measures of economic performance to determine the degree of success or failure of enterprises or to give clear signals to the economy.

41. Is the problem of coordination common to all economies? Explain how the problem is met in a market economy and how coordination was dealt with in a command economy.

The problem of coordination is common to all economies. In a market system, prices adjust the quantity demanded to the quantity supplied. For example, if demand increases for a particular resource, its price will rise until the quantity supplied meets the new quantity demanded. If supply decreases, the price will rise until the quantity demanded declines to the level supplied at a new higher price.

In a planned economy, coordination is done through central planning. Such a system was not market-based, and therefore market forces played an insignificant role in decision-making. Various administrative agencies existed to control the plan, and producer and consumer prices were set by central planners to act as rationing devices.

42. What is the incentive problem in central planning?

In a centrally planned economy the incentives are ineffective for encouraging economic initiative and work, or for directing the most efficient use of productive resources. In a market economy, profits and losses signal what firms should produce, how they should produce, and how productive resources should be allocated to best meet the wants of a nation. Central planning also lacked entrepreneurship and stifled innovation, both of which are important forces for achieving long-term economic growth. Individual workers lacked much motivation to work hard because pay was limited and there were few consumer goods to buy or they were of low quality.

43. "A major reason the economy of the former Soviet Union collapsed was due to a lack of incentives that are provided by the profit system." Evaluate.

A very good case can be made in favor of this statement. The centrally planned system had to rely heavily on the efficient use of resources through better management and increased productivity, but it was those aspects of Soviet central planning that had the greatest flaws.

The profit system would have provided incentives for innovation, productive efficiency, and allocative efficiency that were lacking under the planned system. For example, under a profit system, resources would move toward their most efficient use where they are most in demand. In the planned economy, resources go where the planners direct, which may not be best in terms of society's goals. This meant that consumers had less incentive to work since they couldn't get what they wanted for their efforts. It meant that managers had little incentive to minimize costs, because rewards were based on fulfilling the plan rather than on being efficient. They also had little incentive to innovate or take risks because the reward structure was such that there were penalties for failure, but no economic profits waiting for those who successfully innovated or took risks.

It is the combination of a lack of work incentives and incentives to innovate which point to the conclusion that a profit-based system would have enhanced Soviet economic growth.

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44. (Consider This) Explain the differences in economic systems between North and South Korea and the economic outcomes of the two systems.

North Korea established a command system following the Second World War that emphasized government ownership and central planning. South Korea adopted a market economic system based upon private ownership and the profit motive. The outcomes are striking with South Korea having significantly more economic growth in terms of GDP, GDP per capita and international trade.

45. Describe the basic features of the circular flow diagram.

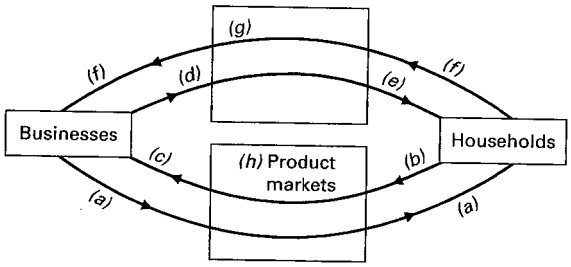
In the simple circular flow diagram, there are two decision-makers: households and businesses. These two groups are related through the resource and product markets. In the upper part of the circular flow, households sell economic resources (land, labor, capital, entrepreneurial ability) and businesses buy resources through the resource market. Businesses pay for the cost of these resources, which in turn becomes money income for households. It is the supply decisions of resources sellers (households) and the buying decisions of businesses that determine prices and employment in the resource market.

In the lower part of the circular flow, businesses sell goods and services and households buy goods and services in the product market. Households pay for these goods and services with the money income they received from providing resources. These consumption expenditures become revenue for businesses. It is the product buying decisions of households and the product selling decisions of businesses that determine prices and output in the product market.

46. What is the relationship between businesses and households in the circular flow diagram?

Households sell their resources to firms in return for money income. Businesses combine the households' labor with other resources to create products. They offer these products for sale to households and in return receive revenue. These revenues to firms enable them to pay for the cost of resources from households as the cycle begins again.

47. In the below circular flow diagram, the household and business sectors are labeled with arrows representing the flows of income and output labeled (a) through (f) and the two appropriate markets labeled (g) and (h). Supply the correct descriptive titles for each of these labels (a) through (h).



(a) Consumption expenditures; (b) Revenue; (c) Goods and services; (d) Money income; (e) Costs; (f) Resources land, labor, capital, entrepreneurial ability; (g) Resource markets.

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48. Describe the flows that occur between (a) households and the product market, (b) businesses and the product market, and (c) households and the resource market.

(a) Resources flow from the product market to households in the form of goods and services produced by businesses. Resources flow from households to the product market in the form of consumption expenditures on goods and services.
(b) Resources flow from businesses to the product market in the form of goods and services the businesses produce. Resources flow from the product market in the form of revenues earned from the sale of goods and services to households.
(c) Resources flow to the resource market from households in the form of labor, land, capital and entrepreneurial ability. Resources flow from the resource market to households in the form of monetary income, such as wages, rents, interest, and profits.

49. In which market would each of the following be determined?
(a) The wage of a lawyer.
(b) The quantity of electric cars produced.
(c) The price of a new television.
(d) The quantity of farm land used to produce corn.

(a) and (d) would be determined in the resource market since the goods in the market are factors of production. (b) and (c) would be determined in the product market. They are produced by businesses and purchased by households.

50. Define the three main categories of businesses.

A sole proprietorship is a business owned and managed by an individual. A partnership is a business organization owned and managed by two or more individuals. A corporation is a legal entity that operates as a business.

51. Explain the main characteristics of a corporation.

Corporations are legal business organizations which are distinct and separate entities from the individuals who own them. As such, corporations are treated as legal persons that can acquire resources, own assets, produce and sell products, incur debts, extend credit, sue and be sued, and carry on all functions which other forms of business enterprises (sole proprietorship or partnership) perform. Professional managers typically run corporations and they are supervised by a board of directors that is elected annually by the corporations' owners. Corporations can be very large, such as Google or Walmart, or quite small, such as a local restaurant or used car dealership.

52. In a market system entrepreneurs or the managers they hire must deal with risk. Discuss the incentives of these individuals when dealing with risk, relative to those of a central planner in a command economy.

Entrepreneurs are guided in making decisions by the profit system (profit and loss system). They must deal with the risk and uncertainty associated with their business that can lead to profits or losses that they often feel directly. Wise decisions must be made to avoid unnecessary risks.

In a command economy, risk management is not as strong. Central planners are government employees may not be directly affected by the outcome of the risk. Employees of the government often receive the same salary no matter the outcome on a risky project or investment.

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53. Describe how business risk affects employees.

Employees are shielded from business risk. When employees are hired, they are offered a contract specifying a given wage based on a time frame for working whether the firm is making a profit or loss. If the firm experiences a loss the owners of the business must find the funds to continue operation or shut down the business. If the firm experiences profits the owners of the business are not required to share the profit with the employees, it is their reward for bearing the risk.

54. Discuss the benefits of restricting business risk to owners and investors.

If business risk is assumed only by the firm's owners and investors it is easier to attract employees and suppliers. Many individuals prefer to avoid risk and like the certainty that a regular paycheck offers. Limiting the risk these individuals bear attracts them to the market.

Another benefit of restricting who bears business risk is that it focuses responsibility and rewards for enduring the risk onto the owners and investors of a firm. The focus of business risk on a relatively small number of people ensures that they are making prudent decisions about the allocation of resources. In a command system, there are many individuals involved in managing risk. This makes it difficult for a sole individual or small group of individuals to assume responsibility for a bad outcome.

55. (Consider This) How does the market for insurance promote economy growth and investment?

Insurance transfers risk from those with low risk tolerance to those with a higher level. When there is a market for insurance those who dislike risk are able to purchase insurance to eliminate a portion of the uncertainty. This allows those with a low tolerance for risk to make investments in the construction and purchase of capital goods like houses and cars, while avoiding some of the risk of fire, theft, and other damages.

56. (Last Word) Explain why the arrangement in the use of resources in a market system is not random given the decentralized nature of the system.

Private property encourages mutual accommodation in a market system. People who own resources seek to obtain the best use of those resources. In doing so, they make the best use of those resources and thus create arrangements of those resources that are used for the production of goods and services that people want.

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