

16. If the price of product X is \$1, the firm will realize
 (a) an economic profit of \$28
 (b) an economic profit of \$27
 (c) an economic profit of \$26
 (d) an economic profit of \$25
17. Now assume that the price of labor falls to \$3 and the price of capital rises to \$5. Which technique is economically most efficient in producing product X?
 (a) A
 (b) B
 (c) C
 (d) D
18. Which is the primary factor determining the share of the total output of the economy received by a household?
 (a) the tastes of the household
 (b) the medium of exchange used by the household
 (c) the prices at which the household sells its resources
 (d) ethical considerations in the operation of a market economy
19. If an increase in the demand for a product and a rise in its price cause an increase in the quantity supplied, price is successfully performing its
 (a) guiding function
 (b) circular flow role
 (c) division-of-labor role
 (d) medium-of-exchange function
20. In the market system, if one firm introduces a new and better method of production that enhances the firm's economic profits, other firms will be forced to adopt the new method to
 (a) increase circular flow
 (b) follow rules for capital accumulation
 (c) avoid economic losses or bankruptcy
 (d) specialize and divide the labor in an efficient way
21. The advent of personal computers and word processing software that eliminated the market for electric typewriters would be an example of
 (a) specialization
 (b) derived demand
 (c) the "invisible hand"
 (d) creative destruction
22. The chief economic virtue of the competitive market system is that it
 (a) allows extensive personal freedom
 (b) promotes the efficient use of resources
 (c) provides an equitable distribution of income
 (d) eliminates the need for decision making
23. In the system of central planning, the outputs of some industries became the inputs for other industries, but a failure of one industry to meet its production target would cause
 (a) widespread unemployment
 (b) inflation in wholesale and retail prices
 (c) profit declines and potential bankruptcy of firms
 (d) a chain reaction of production problems and bottlenecks

24. The two kinds of markets found in the circular flow model are
 (a) real and money markets
 (b) real and socialist markets
 (c) money and command markets
 (d) product and resource markets
25. In the circular flow model, businesses
 (a) buy products and resources
 (b) sell products and resources
 (c) buy products and sell resources
 (d) sell products and buy resources

■ PROBLEMS

1. Use the appropriate number to match the term with the phrase.

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|-------------------------|-------------------------|
| 1. invisible hand | 4. consumer sovereignty |
| 2. coincidence of wants | 5. creative destruction |
| 3. division of labor | 6. specialization |

a. Using the resources of an individual, a firm, a region, or a nation to produce one (or a few) goods and services.

b. The tendency of firms and resource suppliers seeking to further their own self-interest while also promoting the interests of society in a market economy.

c. The situation where new products and production methods eliminate the market position of firms doing business using existing products or older production methods.

d. Splitting the work required to produce a product into a number of different tasks that are performed by different workers.

e. A situation in which the product the first trader wants to sell is the same as the product the second trader wants to buy and the product the second trader wants to sell is the same as the product the first trader wants to buy.

f. Determination by consumers of the types and quantities of goods and services that will be produced in a market economy.

2. 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 \$50 per week. Assume, for the purposes of the problem, that the firm's employment of resources cannot be changed. Their market prices and the quantities of A, B, and C these resources will produce per week are given below. Compute the firm's profit when it produces A, B, or C, and enter those profits in the table below.

Product	Market price	Output	Economic profit
A	\$7.00	8	\$
B	4.50	10	
C	.25	240	

- a. Which product will the firm produce? _____
- b. If the price of A rose to \$8, the firm would _____

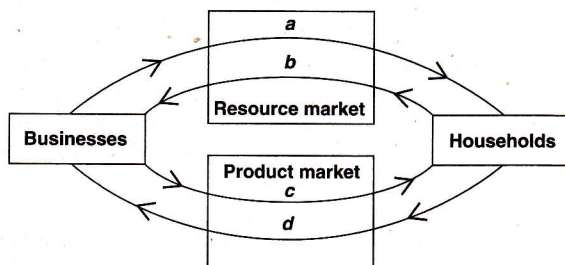
(Hint: You will have to recompute the firm's profit from the production of A.)

- c. If the firm were producing A and selling it at a price of \$8, what would tend to happen to the number of firms producing A?

3. Suppose a firm can produce 100 units of product X by combining labor, land, capital, and entrepreneurial ability in three different ways. If it can hire labor at \$2 per unit, land at \$3 per unit, capital at \$5 per unit, and entrepreneurship at \$10 per unit, and if the amounts of the resources required by the three methods of producing 100 units of product X are as indicated in the table, answer the following questions.

Resource	Method		
	1	2	3
Labor	8	13	10
Land	4	3	3
Capital	4	2	4
Entrepreneurship	1	1	1

- a. Which method is the least expensive way of producing 100 units of X? _____
- b. If X sells for 70 cents per unit, what is the economic profit of the firm? \$ _____
- c. If the price of labor should rise from \$2 to \$3 per unit and if the price of X is 70 cents,
- (1) the firm's use of
- labor would change from _____ to _____
- land would change from _____ to _____
- capital would change from _____ to _____
- entrepreneurship would not change
- (2) The firm's economic profit would change from \$ _____ to \$ _____
4. In the circular flow diagram below, the upper pair of flows (*a* and *b*) represents the resource market and the lower pair (*c* and *d*) represents the product market.



Supply labels or explanations for each of the four flows:

- a. _____
- b. _____
- c. _____
- d. _____

■ SHORT ANSWER AND ESSAY QUESTIONS

- The command system and the market system differ in two important ways. Compare and contrast the two economic systems.
- Explain the major characteristics—institutions and assumptions—embodied in a market system.
- What do each of the following seek if they pursue their own self-interest: consumers, resource owners, and business firms?
- Explain what economists mean by competition. For a market to be competitive, why is it important that there be buyers and sellers and easy entry and exit?
- How does an economy benefit from specialization and the division of labor?
- Give an example of how specialization can benefit two separate and diversely endowed geographic regions.
- What is money? What important function does it perform? Explain how money performs this function and how it overcomes the disadvantages associated with barter.
- In what way do the desires of entrepreneurs to obtain economic profits and avoid losses make consumer sovereignty effective?
- Why is the ability of firms to enter industries that are prosperous important to the effective functioning of competition?
- Explain in detail how an increase in the consumer demand for a product will result in more of the product being produced and more resources being allocated to its production.
- Describe the production factor for businesses that determines what combinations of resources and technologies will be used to produce goods and services.
- Who will get the output from a market economy? Explain.
- How can the market system adapt to change? How is this done?
- How do prices communicate information and guide and direct production in a market economy?
- Explain how the market system provides a strong incentive for technological advance and creative destruction.
- Who "votes" for the production of capital goods, why do they "vote" for capital goods production, and where do they obtain the dollars needed to cast those "votes"?

17. An “invisible hand” operates to identify private and public interests. What are private interests, and what is the public interest? What is it that leads the economy to operate as if it were directed by an invisible hand?

18. Describe the three virtues of the market system.

19. Explain two major economic problems with command economies and then explain why market economies avoid such problems

20. In the circular flow model, what are the two markets? What roles do households play and what roles do businesses play in each market?