Economics 8th edition Hubbard Solutions Manual

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Instructor's Resource Manual for *Economics*

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Economics

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Preface

Features of this Instructor's Manual

Each chapter of this Instructor's Manual contains the following elements:

Chapter Summary: An overview of the main economic concepts covered.

Learning Objectives: A list of the student learning goals listed at the beginning of each text chapter.

Chapter Outline with Teaching Tips: Detailed descriptions of the economic concepts in the book, key term definitions, and teaching tip boxes. The teaching tip boxes include recommendations on how to integrate key figures.

Extra Solved Problems: Each chapter of the main text has a *Solved Problem* to support two of the chapter's learning objectives. This Instructor's Manual includes extra *Solved Problems* that you can assign as homework or present during classroom lectures.

Extra Economics in Your Life: Each chapter of the book opens and closes with a special feature entitled *Economics in Your Life* that emphasizes the connection between the material and the students' personal experiences and questions. This Instructor's Manual includes an extra *Economics in Your Life* for each chapter to present in class.

Extra Apply the Concepts: Each chapter of the main text has two or more *Apply the Concept* features to provide real-world reinforcement of key concepts. This Instructor's Manual includes extra *Apply the Concepts* to present in class.

Solutions to Review Questions and Problems and Applications: Each chapter of this Instructor's Manual includes solutions to all questions and problems in the main text:

- Solutions to the two *Thinking Critically* questions that accompany the *An Inside Look* newspaper feature located at the end of Chapters 1, 2, 3, and 4
- Solutions to the end-of-chapter Review Questions
- Solutions to the end-of-chapter Problems and Applications
- Solutions to the end-of-chapter Real-Time-Data Exercises

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Digital Assets Located in MyLab Economics

MyLab Economics is a unique online course management, testing, and tutorial resource. It is included with the complete eText as well as these additional online resources to accompany the eighth edition.

- **Videos.** There are more than 130 *Apply the Concept* features in the book that provide real-world reinforcement of key concepts. Each feature is accompanied by a two- or three-minute video of the author explaining the key point of that *Apply the Concept*. Related assessment is included with each video, so students can test their understanding. The goal of these videos is to summarize key content and bring the applications to life. In our experience, many students benefit from this type of online learning and assessment.
- **Concept Checks.** Each section of each learning objective concludes with an online Concept Check that contains one or two multiple-choice, true/false, or fill-in questions. These checks act as "speed bumps" that encourage students to stop and check their understanding of fundamental terms and concepts before moving on to the next section. The goal of this digital resource is to help students assess their progress on a section-by-section basis, so they can be better prepared for homework, quizzes, and exams.
- **Animations of Figures.** Graphs are the backbone of introductory economics, but many students struggle to understand and work with them. Each of the more than 250 numbered figures in the text has a supporting animated version online. The goal of this digital resource is to help students understand shifts in curves, movements along curves, and changes in equilibrium values. Having an animated version of a graph helps students who have difficulty interpreting the static version in the printed text. Graded practice exercises are included with the animations. In our experience, many students benefit from this type of online learning.
- **Whiteboard *Solved Problem* Videos.** Many students have difficulty applying economic concepts to solving problems. Each chapter includes between one and three *Solved Problems* that show students how to break an economic problem down step by step. Several of these *Solved Problems* are also available as whiteboard videos. The goals of the feature and whiteboard videos are to help students build skills they can use to analyze real-world economic issues they hear and read about in the news and also to help students apply basic problem-solving skills to homework, quizzes, and exams. Each *Solved Problem* in the book and in video format includes at least one additional graded practice exercise for students.
- **Graphs Updated with Real-Time Data from FRED.** Select graphs are continuously updated online with the latest available data from FRED (Federal Reserve Economic Data), which is a comprehensive, up-to-date data set maintained by the Federal Reserve Bank of St. Louis. Students can display a pop-up graph that shows new data plotted in the graph. The goal of this digital feature is to help students understand how to work with data and understand how including new data affects graphs.
- **Interactive Problems and Exercises Updated with Real-Time Data from FRED.** The end-of-chapter problems in select chapters include *Real-Time Data Exercises* that use the latest data from FRED. The goals of this digital feature are to help students become familiar with this key data source, learn how to locate data, and develop skills in interpreting data.

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Organizing Your Syllabus

The Instructor's Manual can be a valuable resource for both experienced and first-time instructors. Both the textbook and Instructor's Manual provide comprehensive coverage of economic theory, monetary policy, fiscal policy, and real-world applications.

Microeconomic Chapters

The microeconomics chapters cover relatively new developments in the field, such as the economics of information (Chapter 7, "The Economics of Health Care") and personnel economics (Chapter 16, "The Markets for Labor and Other Factors of Production"). The authors include business applications in each chapter and have a dedicated chapter on firms, the stock market, and corporate governance (Chapter 8, "Firms, the Stock Market, and Corporate Governance"). The comprehensive coverage of microeconomics and business topics allows instructors to select chapters for diverse groups of students.

Most instructors will not want to cover indifference curve analysis, but those who wish to will find this topic covered in the appendix to Chapter 10, "Consumer Choice and Behavioral Economics." An online appendix is available for instructors who wish to cover isoquant and isocost curves to accompany Chapter 11, "Technology, Production, and Costs." Chapter 14 of this instructor's manual, "Oligopoly: Firms in Less Competitive Markets," includes coverage of the kinked demand curve that *does not* appear in the main book.

First-time users of the textbook should be aware that some topics introduced in one chapter are applied in a later chapter. Chapter 4, "Economic Efficiency, Government Price Setting, and Taxes," introduces consumer, producer, and economic surplus to describe the impact of government-imposed price controls. The appendix to Chapter 4, "Quantitative Demand and Supply Analysis," explains in detail how consumer and producer surplus are calculated using linear demand and supply curves. Chapter 9, "Comparative Advantage and the Gains from International Trade," uses the same tools to measure the effect of tariffs and quotas on international trade.

Macroeconomic Chapters

Chapter 18, "GDP: Measuring Total Production and Income," and Chapter 19, "Unemployment and Inflation" carefully provide definitions of macroeconomic statistics such as GDP, CPI, and payroll employment, that dominate news headlines.

The comprehensive coverage of macroeconomic models and policy issues allows instructors with somewhat different course objectives the flexibility to choose different chapter sequences. The authors provide an overview of issues of long-run growth, business cycles, and the financial system in Chapter 20, "Economic Growth, the Financial System, and Business Cycles." Instructors who wish to explore more deeply the sources of long-run growth and government policies toward growth can also assign Chapter 21, "Long-Run Economic Growth: Sources and Policies." Monetary policy has a central role in the economy, so the book includes two chapters on monetary policy: Chapter 25, "Monetary Policy," and Chapter 27, "Inflation, Unemployment, and Federal Reserve Policy." Chapter 27 discusses the role of the Fed and inflation targeting with an insider's perspective.

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Chapter 22, "Aggregate Expenditure and Output in the Short Run," contains a thorough discussion of the traditional Keynesian 45º-line aggregate expenditure model. Many instructors find this model useful in introducing students to the short-run relationship between spending and production. However, instructors may also safely omit Chapter 22 and proceed directly to Chapter 23, "Aggregate Demand and Aggregate Supply Analysis."

Chapter 23 carefully develops the *AD-AS* model and then makes the model dynamic in an *optional section* to account better for actual movements in real GDP and the price level. Instructors may safely omit the sections on the dynamic *AD-AS* model in Chapter 25, "Monetary Policy" and in Chapter 26, "Fiscal Policy," without any loss in continuity to the discussion of macroeconomic theory and policy.

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The following chart helps you organize your syllabus based on your teaching preferences and objectives:

CORE	POLICY	OPTIONAL
Chapter 1: Economics: Foundations and Models	Chapter 4: Economic Efficiency, Government Price Setting, and Taxes	Chapter 1 Appendix: Using Graphs and Formulas
Chapter 2: Trade-offs, Comparative Advantage, and the Market System	Chapter 5: Externalities, Environmental Policy, and Public Goods	Chapter 4 Appendix: Quantitative Demand and Supply Analysis
Chapter 3: Where Prices Come From: The Interaction of Demand and Supply	*This chapter may be delayed until after Ch. 15.*	Chapter 8: Firms, the Stock Market, and Corporate Governance
Chapter 6: Elasticity: The Responsiveness of Demand and Supply	Chapter 7: The Economics of Health Care	Chapter 8 Appendix: Present Value
Chapter 9: Comparative Advantage and the Gains from International Trade	Chapter 16: Public Choice, Taxes, and the Distribution of Income	Chapter 8 Online Appendix: Income Statements and Balance Sheets
May be delayed until after Ch. 27.	Chapter 25: Monetary Policy	Chapter 10: Consumer Choice and Behavioral Economics
Chapter 11: Technology, Production, and Costs	Chapter 26: Fiscal Policy	Chapter 10 Appendix: Using Indifference Curves and Budget Lines to Understand Consumer Behavior
Chapter 12: Firms in Perfectly Competitive Markets	Chapter 27: Inflation, Unemployment, and Federal Reserve Policy	Chapter 11 Online Appendix: Using Isoquants and Isocost Lines to Understand Production and Cost
Chapter 13: Monopolistic Competition: The Competitive Model in a More Realistic Setting		Chapter 22: Aggregate Expenditure and Output in the Short Run
Chapter 14: Oligopoly: Firms in Less Competitive Markets		Chapter 22 Appendix: The Algebra of Macroeconomic Equilibrium
Chapter 15: Monopoly and Antitrust Policy		Chapter 23 Appendix: Macroeconomic Schools of Thought
May be covered after Ch. 12.		Chapter 26 Appendix: A Closer Look at the Multiplier
Chapter 16: The Markets for Labor and Other Factors of Production		Chapter 28: Macroeconomics in an Open Economy
Chapter 18: GDP: Measuring Total Production and Income		Chapter 28 Online Appendix: The Gold Standard and the Bretton Woods System
Chapter 19: Unemployment and Inflation		
Chapter 20: Economic Growth, the Financial System, and Business Cycles		
Chapter 21: Long-Run Economic Growth: Sources and Policies		
Chapter 23: Aggregate Demand and Aggregate Supply Analysis		
This chapter carefully develops the AD-AS model and then makes the model dynamic to better account for actual movements in real GDP and the price level. The dynamic AD-AS model is covered in an optional section, which instructors can omit without loss of continuity.		
Chapter 24: Money, Banks, and the Federal Reserve System		

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Other Supplements

Supplements Available to Instructors for Download at www.pearsonhighered.com	**Features of the Supplement**
Two Test Banks for *Microeconomics* and for *Macroeconomics* Authored by Randy Methenitis of Richland College	• Each volume includes 4,000 multiple-choice, true/false, short-answer, and graphing questions. • Test questions are annotated with the following categories: **Difficulty**—1 for straight recall, 2 for some analysis, and 3 for complex analysis **Type**—multiple-choice, true/false, short-answer, essay **Topic**—the term or concept the question supports **Learning outcome** **Page number** in the main book **Special feature** in the main book **The Association to Advance Collegiate Schools of Business** (AACSB) **Guidelines,** which propose learning experiences in the following categories of Assurance of Learning Standards: Written and Oral Communication; Ethical Understanding and Reasoning; Analytical Thinking; Information Technology; Interpersonal Relations and Teamwork, Diverse and Multicultural Work; Reflective Thinking; and Application of Knowledge
Computerized TestGen	• Allows instructors to customize, save, and generate classroom tests. • Instructors can edit, add, or delete questions from the Test Banks; analyze test results; and organize a database of tests and student results. • Many options are available for organizing and displaying tests, along with search and sort features. • The software and the Test Banks can be downloaded from www.pearsonhighered.com.

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Supplements Available to Instructors for Download at www.pearsonhighered.com	**Features of the Supplement**
PowerPoint Lecture Presentations Authored by Paul Holmes of Ashland University	• A comprehensive set of PowerPoint slides can be used by instructors for class presentations or by students for lecture preview or review. These slides include all the graphs, tables, and equations in the textbook. Two versions are available: step-by-step mode, in which you can build graphs as you would on a blackboard, and automated mode, in which you use a single click per slide. • Student versions of the PowerPoint slides are available as .pdf files. This version allows students to print the slides and bring them to class for note taking.

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CHAPTER 1 | Economics: Foundations and Models

Brief Chapter Summary and Learning Objectives

1.1 Three Key Economic Ideas (pages 4–7)
Explain these three key economic ideas: People are rational, people respond to economic incentives, and optimal decisions are made at the margin.

- Because resources are scarce, people must make choices to attain their goals.

1.2 The Economic Problem That Every Society Must Solve (pages 8–11)
Discuss how an economy answers these questions: What goods and services will be produced? How will the goods and services be produced? Who will receive the goods and services produced?

- Because of scarcity, producing more of one good or service means that less of some other good or service will be produced.

1.3 Economic Models (pages 11–15)
Explain how economists use models to analyze economic events and government policies.

- Economists use models—simplified versions of reality—to analyze real-world issues.

1.4 Microeconomics and Macroeconomics (page 15-16)
Distinguish between microeconomics and macroeconomics.

1.5 Economic Skills and Economics as a Career (pages 16–17)
Describe economics as a career and the key skills you can gain from studying economics.

1.6 A Preview of Important economic Terms (pages 17–19)
Define important economic terms.

Appendix: Using Graphs and Formulas (pages 27–39)
Use graphs and formulas to analyze economic situations.

Key Terms

Allocative efficiency, p. 10. A state of the economy in which production is in accordance with consumer preferences; in particular, every good or service is produced up to the point where the last unit provides a marginal benefit to consumers equal to the marginal cost of producing it.

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Centrally planned economy, p. 9. An economy in which the government decides how economic resources will be allocated.

Economic model, p. 11. A simplified version of reality used to analyze real-world economic situations.

Economic variable, p. 12. Something measurable that can have different values, such as the number of people employed in manufacturing.

Economics, p. 4. The study of the choices people make to attain their goals, given their scarce resources.

Equity, p. 11. The fair distribution of economic benefits.

Macroeconomics, p. 15. The study of the economy as a whole, including topics such as inflation, unemployment, and economic growth.

Marginal analysis, p. 6. Analysis that involves comparing marginal benefits and marginal costs.

Market, p. 4. A group of buyers and sellers of a good or service and the institution or arrangement by which they come together to trade.

Market economy, p. 9. An economy in which the decisions of households and firms as they interact in markets determine the allocation of economic resources.

Microeconomics, p. 15. The study of how households and firms make choices, how they interact in markets, and how the government attempts to influence their choices.

Mixed economy, p. 10. An economy in which most economic decisions result from the interaction of buyers and sellers in markets but in which the government plays a significant role in the allocation of resources.

Normative analysis, p. 13. Analysis concerned with what ought to be.

Opportunity cost, p. 8. The highest-valued alternative that must be given up to engage in an activity.

Positive analysis, p. 13. Analysis concerned with what is.

Productive efficiency, p. 10. A situation in which a good or service is produced at the lowest possible cost.

Scarcity, p. 4. A situation in which unlimited wants exceed the limited resources available to fulfill those wants.

Trade-off, p. 8. The idea that, because of scarcity, producing more of one good or service means producing less of another good or service.

Voluntary exchange, p. 10. A situation that occurs in markets when both the buyer and the seller of a product are made better off by the transaction.

Chapter Outline

Does Apple Manufacture the iPhone in the United States?

Although Apple designs the iPhone at its headquarters in Cupertino, California, most iPhones are assembled in China. Many products that were once manufactured in the United States are now manufactured overseas. The Trump administration imposed tariffs on Chinese imports in 2019. Tariffs lead to higher prices for imported goods, making it more likely that U.S. and foreign companies will manufacture goods in the United States. The Trump administration also hoped that the tariffs would convince other countries to reduce restrictions on U. S. imports. In a market system, firms respond to economic incentives. In in case of Apple, lower wages earned by Chinese workers reduce the costs of assembling iPhones. Technological

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progress often creates incentives for firms to change how they produce goods and services. Firms also respond to changes in consumer tastes and to changes in government policy. In 2019, many firms awaited the outcome of trade negotiations between China and the United Stated before deciding in which country to expand their operations.

Teaching Tips

There are special features in the textbook:

1. The introduction, or chapter opener, uses a real-world business example to preview the economic issues discussed in the chapter.
2. At the end of each of the first four textbook chapters is a feature titled An Inside Look that consists of a recent news article plus analysis and questions. The article links back to a topic discussed in the chapter opener. Visit MyLabEconomics for additional current An Inside Look news articles.
3. A boxed feature titled Economics in Your Life & Career complements the business example that opens the chapter. Economics in Your Life and Career poses questions that help students make a personal connection with the chapter theme. At the end of the chapter, the authors use the concepts described in the chapter to answer these questions. *Extra* Economics in Your Life & Career features are included in the Instructor's Manual.
4. Don't Let This Happen to You is a box feature that alerts students to common pitfalls covered in that chapter.
5. There are between two and four Analyze the Concept features in each chapter that provide real world reinforcement of key concepts by citing news stories that focus on business and policy issues. *Extra* Analyze the Concept features appear in the Instructor's Manual.
6. Solved Problems use a step-by-step process for solving economic problems related to a chapter's learning objectives. *Extra* Solved Problems are included in the Instructor's Manual.
7. Real-Time Data Exercises (RTDA) are included with problems at the end of macroeconomics chapters. These problems refer to data and graphs that students will find at the web site of the Federal Reserve Bank of St. Louis (FRED). Many RTDA require more elaborate calculations than other problems and the use of Excel spreadsheets.

You can use these features as the basis for classroom discussion, homework assignments, and examination questions.

People must make choices as they try to attain their goals. The choices people make represent the trade-offs made necessary by scarcity. **Scarcity** is a situation in which unlimited wants exceed the limited resources available to fulfill those wants. **Economics** is the study of the choices people make to attain their goals, given their scarce resources.

Teaching Tips

Students will better understand what scarcity means if given examples of things that are *not* scarce. Suggest examples of "free" resources—sand on a beach, fresh air, etc.—and ask your students to contribute their own examples; they will soon realize that the list of free resources is much shorter than the list of scarce resources.

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1.1 Three Key Economic Ideas (pages 4–7)

Learning Objective: Explain these three key economic ideas: People are rational, people respond to economic incentives, and optimal decisions are made at the margin.

A **market** is a group of buyers and sellers of a good or service and the institution or arrangement by which they come together to trade.

A. People Are Rational

Rational consumers and firms use all available information as they act to achieve their goals. Although not everyone behaves rationally all the time, the assumption of rational behavior is useful in explaining most of the choices people make.

B. People Respond to Economic Incentives

Economists emphasize that individuals and firms consistently respond to economic incentives.

C. Optimal Decisions Are Made at the Margin

Economists use the word marginal to mean an extra or additional benefit or cost from making a decision. The optimal decision is to continue any activity to the point where the marginal benefit equals the marginal cost. **Marginal analysis** is analysis that involves comparing marginal benefits and marginal costs.

Extra Solved Problem 1.1

A Doctor Makes a Decision at the Margin

A doctor receives complaints from patients that her office isn't open enough hours. In response, the doctor asks her office manager to analyze the effect of keeping her office open 9 hours per day rather than 8 hours. The doctor's office manager tells her: "Keeping the office open an extra hour is a good idea because the revenue from your practice will increase by $300,000 per year when the office is open 9 hours per day." Do you agree with the office manager's reasoning? What, if any, additional information would you need to decide whether the doctor should keep her office open an additional hour per day?

Solving the Problem

Step 1: **Review the chapter material.**
This problem is about making decisions, so you may want to review the section "Optimal Decisions Are Made at the Margin" in the textbook.

Step 2: **Explain whether you agree with the office manager's reasoning.**
We have seen that any activity should be continued to the point where the marginal benefit is equal to the marginal cost. In this case, the doctor should keep her office open up to the point where the additional revenue she receives from seeing more patients is equal to the marginal cost of keeping her office open an additional hour. The office manager has provided information on marginal revenue but not on marginal cost. The office manager has not provided enough information to make a decision, and you should not agree with the office manager's reasoning.

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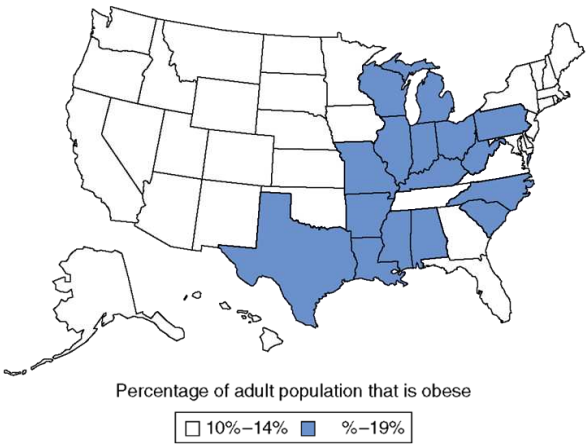
Step 3: **Explain what additional information you need.**
To make a correct decision, you would need information on the marginal cost of remaining open an extra hour per day. The marginal cost would include the additional salary to be paid to the office staff, any additional medical supplies that would be used, as well as any additional electricity or other utilities. The doctor would also need to take into account the nonmonetary cost of spending another hour working rather than spending time with her family and friends or in other leisure activities. The marginal revenue would depend on how many more patients the doctor can see in the extra hour. The doctor should keep her office open an additional hour if the marginal revenue of doing so is greater than the marginal cost. If the marginal cost is greater than the marginal revenue, then the doctor should continue to keep her office open for 8 hours.

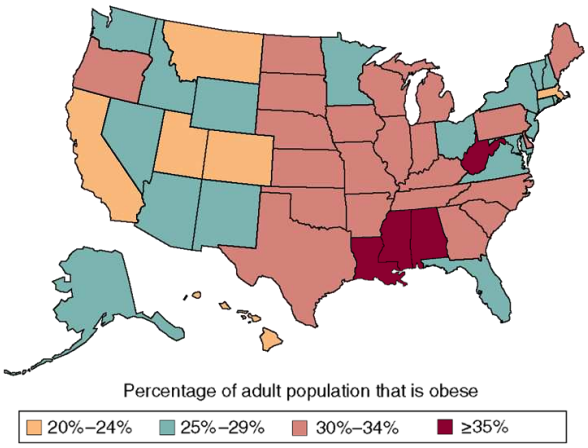
Extra Analyze the Concept

Does Health Insurance Give People an Incentive to Become Obese?

Obesity is a factor in a variety of diseases, including heart disease, stroke, diabetes, and hypertension, making it a significant health problem in the United States. Body mass index (BMI) is a measurement of a person's weight relative to the person's height. According to the U.S. Centers for Disease Control and Prevention (CDC), an adult with a body mass index (BMI) of 30 or greater is considered *obese*. For example, a 5'6" adult with a BMI of 30 is 40 pounds overweight.

The following two maps show the dramatic increase in obesity between 1994 and 2015. In 1994, in a majority of states only between 10 percent and 14 percent of the adult population was obese, and in no state was more than 20 percent of the adult population obese.





By 2015, in every state, at least 20 percent of the adult population was obese, and in 44 states, at least 25 percent of the adult population was obese. Many people who suffer from obesity have underlying medical conditions. For these people, obesity is a medical problem that they cannot control. The fact that obesity has increased, though, indicates that for some people, obesity is the result of diet and lifestyle choices. Potential explanations for the increase in obesity include greater intake of high-calorie fast foods, insufficient exercise, and a decline in the physical activity associated with many jobs. The CDC recommends that teenagers get a minimum of 60 minutes of aerobic exercise per day, a standard that only 15 percent of high school students meet. In 1960, 50 percent of jobs in the United States required at least

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moderate physical activity. Today, only 20 percent of jobs do. As a result, a typical worker today who may work at a computer is burning off about 130 *fewer* calories per workday than a worker in the 1960s who was more likely to have worked in a manufacturing plant.

In addition to eating too much and not exercising enough, could having health insurance be a cause of obesity? Obese people tend to suffer more medical problems and so incur higher medical costs. Obese people with health insurance that will reimburse them for only part of their medical bills, or who have no health insurance, must pay some or all of these higher medical bills themselves. People with health insurance that covers most of their medical bills will not suffer as large a monetary cost from being obese. In other words, by reducing some of the costs of obesity, health insurance may give people an economic incentive to gain weight.

At first glance, this argument may seem implausible. Some people suffer from medical conditions that can make physical activity difficult or that can cause weight gain even with moderate eating, so they may become obese, regardless of which type of health insurance they have. The people who are obese because of poor eating habits or lack of exercise probably don't consider health insurance when deciding whether to have a slice of chocolate cake or to watch Netflix instead of going to the gym. But if economists are correct about the importance of economic incentives, then we would expect that if we hold all other personal characteristics—such as age, gender, and income—constant, people with health insurance will be more likely to be overweight than people without health insurance.

Jay Bhattacharya and Kate Bundorf of Stanford University, Noemi Pace of the University of Venice, and Neeraj Sood of the University of Southern California, have analyzed the effects of health insurance on weight. Using a sample that followed nearly 80,000 people from 1989 to 2004, they found that after controlling for factors including age, gender, income, education, and race, people with health insurance were significantly more likely to be overweight than people without health insurance. Having private health insurance increased BMI by 1.3 points. Having public health insurance, such as Medicaid, which is a program under which the government provides health care to low-income people, increased BMI by 2.3 points. These findings suggest that people respond to economic incentives even when making decisions about what they eat and how much they exercise.

Note: The exact formula for the body mass index is BMI = (Weight in pounds/Height in inches2) x 703.

Sources: Centers for Disease Control and Prevention, "Prevalence of Self-Reported Obesity among U.S. Adults," www.cdc. gov; Katherine M. Flegal, Margaret D. Carroll, Cynthia L. Ogden, and Lester R. Curtin, "Prevalence and Trends in Obesity among U.S. Adults, 1999–2008," *Journal of the American Medical Association*, Vol. 303, No. 3, January 20, 2010, pp. 235–241; Jay Bhattacharya, Kate Bundorf, Noemi Pace, and Neeraj Sood, "Does Health Insurance Make You Fat?" in Michael Grossman and Naci H. Mocan, eds., *Economic Aspects of Obesity*, Chicago: University of Chicago Press, 2011; and Tara Parker-Pope, "Less Active at Work, Americans Have Packed on Pounds," *New York Times*, May 25, 2011.

Teaching Tips

You don't need to spend a lot of class time explaining the material in this section; subsequent chapters will reinforce students' understanding of markets and the "three key economic ideas."

1.2 The Economic Problem That Every Society Must Solve (pages 8–11)

Learning Objective: Discuss how an economy answers these questions: What goods and services will be produced? How will the goods and services be produced? Who will receive the goods and services produced?

Every society faces the economic problem that it has only a limited amount of economic resources, so it can produce only a limited amount of goods and services. Every society faces trade-offs. A **trade-off** is the

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idea that, because of scarcity, producing more of one good or service means producing less of another good or service. Every activity has an **opportunity cost**: The highest-valued alternative that must be given up to engage in an activity. Trade-offs force society to answer three fundamental questions:

1. *What* goods and services will be produced?
2. *How* will the goods and services be produced?
3. *Who* will receive the goods and services produced?

A. What Goods and Services Will Be Produced?

The answer to this question is determined by the choices consumers, managers of firms, and government policymakers make. Each choice made has an opportunity cost.

B. How Will the Goods and Services Be Produced?

Firms choose how to produce the goods and services they sell. For example, firms often face trade-offs between using more workers or more machines.

C. Who Will Receive the Goods and Services Produced?

In the United States, who receives the goods and services produced depends largely on how income is distributed. An important policy question is whether the government should intervene to make the distribution of income more equal.

D. Centrally Planned Economies versus Market Economies

Societies organize their economies in two main ways. A **centrally planned economy** is an economy in which the government decides how economic resources will be allocated. A **market economy** is an economy in which the decisions of households and firms interacting in markets determine the allocation of economic resources. Today, only North Korea has a completely centrally planned economy. In a market economy, the income of an individual is determined by the payments he or she receives for what he or she sells. Generally, the more extensive the training a person has received and the longer the hours the person works, the higher his income will be.

E. The Modern "Mixed" Economy

The high rates of unemployment and business bankruptcies during the Great Depression of the 1930s caused a dramatic increase in government intervention in the economy in the United States and other market economies. Some government intervention is designed to raise the incomes of the elderly, the sick, and people with limited skills. In recent years, government intervention has expanded to meet goals such as protection of the environment, promotion of civil rights, and increased access to medical care.

Some economists argue that the extent of government intervention makes it more accurate to refer to the economies of the United States, Canada, Japan and Western Europe as mixed economies rather than pure market economies. A **mixed economy** is an economy in which most economic decisions result from the interaction of buyers and sellers in markets but in which the government plays a significant role in the allocation of resources.

F. Efficiency and Equity

Market economies tend to be more efficient than centrally planned economies. There are two types of efficiency. **Productive efficiency** is a situation in which a good or service is produced at the lowest possible cost. **Allocative efficiency** is a state of the economy in which production is in accordance with consumer preferences; in particular, every good or service is produced up to the point where the last unit provides a marginal benefit to consumers equal to the marginal cost of producing it. **Voluntary exchange** is a situation that occurs in markets when both the buyer and the seller of a product are made better off by the transaction.

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Inefficiency arises from various sources. Sometimes governments reduce efficiency by interfering with voluntary exchange in markets. The production of some goods damages the environment when firms ignore the costs of environmental damage. In this case, government intervention can increase efficiency.

Society may not find an efficient economic outcome to be desirable. Many people prefer economic outcomes they consider fair or equitable even if these outcomes are less efficient. **Equity** is the fair distribution of economic benefits. There is often a trade-off between efficiency and equity.

Teaching Tips

Ask students for examples of government regulation of private markets in the United States. Responses may include: making the sale of cocaine and other addictive drugs illegal; minimum age requirements for the purchase of alcoholic beverages and cigarettes; the prohibition of the sale of new drugs before their effectiveness is demonstrated through government supervised tests. Ask students whether one of these examples of government regulation promotes equity or fairness. The difficulty in defining equity will be apparent.

To show how students may value equity less than they claim, an economics teacher at a college in Western New York once told her students at the beginning of her course that their grades would be auctioned to the highest bidders. Because grades are usually normally distributed, she offered to sell a few A grades, a few more B grades, and so on. Although the announcement produced shock and grumbling, the auction proceeded, with frenzied bidding for A grades. As prices for A grades rose, bidding switched to B grades. Because few students bothered to bid for C grades, one enterprising student bid on several such grades in the belief that those who lost out on getting an A or B would have to buy their C grades from him—for a higher price than he paid! After about a week, the instructor informed the class the auction was intended only as an economics lesson; they would have to earn their grades the old-fashioned way.

Extra Solved Problem 1.2

Advising New Government Leaders

Suppose a country experiences a change in government leadership. Prior to this change, this country had a centrally planned economy. The new leaders are willing to try a different system if they can be convinced that it will yield better results. They hire an economist from a country with a market economy to advise them and will order their citizens to follow the economist's recommendations for change. The economist suggests that a market economy replace central planning to answer the nation's economic questions (*what*, *how*, and *who*?).

What will the economist suggest the leaders order their citizens to do in order to change from a centrally planned economy to a market economy?

Are there reasons why the leaders of this country might not accept the economist's suggestions? Briefly explain.

Solving the Problem

Step 1: **Review the chapter material.**
The problem is about different types of economic systems, so you may want to review the section "Centrally Planned Economies versus Market Economies" in the textbook.

Step 2: **What will the economist suggest the leaders order their citizens to do?**

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Market economies allow members of households to select occupations and purchase goods and services based on self-interest and allow privately owned firms to produce goods and services based on their self-interests. Therefore, the economist would advise the leaders of the country to not issue any orders. Government officials should have no influence over individual decisions made in markets.

Step 3: **Are there reasons why the leaders of this country might not accept the economist's suggestions?**
Even democratically elected leaders may find it difficult to accept the economist's suggestions. They may wonder how self-interested individuals will produce and distribute goods and services so as to promote the welfare of the entire country. This new system requires a significant reduction in government influence in people's lives, but history has shown that most government officials are reluctant to give up this influence. Acceptance is most likely when the leaders have some knowledge and experience with the successful operation of a market economy in other countries. Ordinary citizens are more likely to accept the economist's suggestions because they would have more freedom to pursue their own economic goals.

Extra Analyze the Concept

It's Saturday Afternoon: Why Aren't You at the Game?

For many students, attending college football games is an enjoyable way to spend Saturday afternoons in the fall. However, some colleges have experienced a decline in the number of students attending their games. In 2016, average attendance at the 130 schools that make up the Division I Football Bowl Subdivision (43,106) was the lowest since 2000 (42,631).

What explains the decrease in the number of students willing to attend football games? Rising ticket prices are one reason for the decline. One student at the University of Michigan was quoted as saying: "People are looking to trim costs, and for a lot of folks, football is an easy thing to cut. It's not essential to going to college."

Remember that the opportunity cost of engaging in an activity is the value of the best alternative that must be given up to engage in that activity. The opportunity cost of attending a college football game is *not* just the price of a ticket. If the price of a ticket to a game is $50, your opportunity cost is the ticket price *plus* the value you place on what else you could do if you don't attend the game. At one time, relatively few college football games were televised, but today multiple cable networks broadcast games. If you attend your college's games, you miss the opportunity to watch the games being broadcast at the same time—in high-definition with replays shown from multiple camera angles and expert commentary to clarify what is happening. When watching games in your room or at a sports restaurant, you can also post to Facebook, Instagram, or Twitter, read e-mail, surf the Web, and take or receive phone calls. Wi-Fi and cellular reception are often poor in college stadiums, making these activities difficult.

So the opportunity cost of attending college football games has increased in recent years, not just because ticket prices have risen but because the number of alternative activities that students value highly has also increased. We expect that when the opportunity cost of engaging in an activity increases, people will engage in that activity less, as we've seen with student attendance at college football games.

Colleges have responded to declining student attendance by reducing ticket prices, improving Wi-Fi and cellular service, and installing high-definition video boards that show replays as they appear on

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television. Whether these attempts to lower the opportunity cost of attending college football games enough to increase attendance at games remains to be seen.

Sources: Jon Solomon, "College Attendance in 2016: Crowds Decline for the Sixth Straight Year," *CBSSports.com*, December 16, 2016; Adam Rittenberg, "Attendance Challenges Big Deal for B1G," espn.com, February 14, 2014; and Ben Cohen, "At College Football Games, Student Sections Likely to Have Empty Seats," *Wall Street Journal*, August 27, 2014.

1.3 Economic Models (pages 11–15)

Learning Objective: Explain how economists use models to analyze economic events and government policies.

An **economic model** is simplified version of reality used to analyze real-world situations. To develop a model, economists generally follow five steps.

1. Decide on the assumptions to use.
2. Formulate a testable hypothesis.
3. Use economic data to test the hypothesis.
4. Revise the model if it fails to explain the economic data well.
5. Retain the revised model to help answer similar economic questions in the future.

A. The Role of Assumptions in Economic Models

Models are based on making assumptions because models must be simplified to be useful. When using models, economists make behavioral assumptions about the motives of consumers and firms. Economists assume consumers will buy goods and services that will maximize their satisfaction and firms will act to maximize their profits.

B. Forming and Testing Hypotheses in Economic Models

An **economic variable** is something measurable that can have different values, such as the number of people employed in manufacturing. A hypothesis in an economic model is a statement that may be correct or incorrect about an economic variable. To test a hypothesis, we analyze statistics on the relevant economic variables. Economists accept and use an economic model if it leads to hypotheses that are confirmed by statistical analysis.

C. Positive and Normative Analysis

Positive analysis is analysis concerned with what is. **Normative analysis** is analysis concerned with what ought to be. Economics is about positive analysis, which measures the costs and benefits of different courses of action.

D. Economics as a Social Science

Because economics studies the actions of individuals, it is a social science. Economics considers human behavior in every context, not just in the context of business. Economists have played an important role in formulating government policies in areas such as the environment, health care, and poverty.

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Extra Solved Problem 1.3

Snowfalls and Skiing

Marsha Shawn is a college student and downhill skier who lives near The Ski Chalet, a ski resort located in Vermont. For a course project Marsha and four other students are required to develop an economic model. Marsha suggests that their model test the impact of snowfalls on the sale of ski equipment (skis, boots, poles) and snowboards at the six ski shops located within a ten-mile radius of The Ski Chalet. Marsha and the other students in her group agree that to have an impact on equipment sales a snowfall would have to result in at least four inches of new snow. How would you recommend that Marsha and the other students develop their model? Suggest an alternative model for Marsha in the event that the model fails to explain the data she uses to test her model.

Solving the Problem

Step 1: **Review the chapter material.**
The problem is about how to use models to analyze economic issues, so you may want to review the section "Economic Models" in the textbook.

Step 2: **To develop and test a model of the relationship between snowfall and sales of ski equipment the students in Marsha's group should follow these steps:**

1. *Decide on the assumptions to use in developing the model*. For example: sales of ski equipment and snowboards are greater after snowfalls (four or more inches) than are sales at other times during the period that The Ski Chalet is open.
2. *Formulate a testable hypothesis*. Sales of ski equipment and snowboards at the six ski shops located near the Ski Chalet are higher (for example, by 5 percent or more) within one week following snowfalls of four or more inches than other weeks that The Ski Chalet is open.
3. *Use economic data to test the hypothesis*. Marsha's group must obtain sales data from the six Vermont ski shops and agree on the number of observations (including the number of times a snowfall of at least four inches is observed) required to test the hypothesis.
4. *Revise the model if it fails to explain the economic data well. Suggest an alternative model.* The model could fail if large numbers of skiers and snowboard owners buy their equipment prior to the months that The Ski Chalet is open, or if large numbers rent, rather than purchase, their equipment. One alternative model would compare the sales of lift tickets or rental equipment in weeks following snowfalls of four or more inches and other weeks during the time The Ski Chalet is open.
5. *Retain the revised model to help answer similar economic questions in the future*. If the data support the model, one can assume that there is a relationship between snowfalls and equipment sales. Tests of the model with data from different time periods or in different locations could either support or refute these results. Acceptance of a model is always tentative pending the acquisition of new data or additional statistical analysis.

1.4 Microeconomics and Macroeconomics (page 15-16)

Learning Objective: Distinguish between microeconomics and macroeconomics.

Microeconomics is the study of how households and firms make choices, how they interact in markets, and how the government attempts to influence their choices.

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Macroeconomics is the study of the economy as a whole, including topics such as inflation, unemployment, and economic growth.

Extra Solved Problem 1.4

Microeconomic and Macroeconomic Views

Sports fans are used to watching events on television from different camera angles. For popular events such as the Olympics, the World Series, and the Super Bowl, network coverage captures action from ground level as well as higher locations. Blimps are frequently flown above the stadiums and ballparks where the events take place. The aerial view of the blimp's camera is visually appealing but is never broadcast for very long because the athletes are barely visible. Coverage of games includes a view from a mobile or "sideline" camera that can zoom in on individual players or fans sitting in the stands, a degree of detail much greater than that provided by the aerial view.

How do the different camera angles help to explain the difference between microeconomics and macroeconomics?

Solving the Problem

Step 1: **Review the chapter material.**
The problem concerns the differences between microeconomics and macroeconomics, so you may want to review the section "Microeconomics and Macroeconomics" in the textbook.

Step 2: **Compare the focus of microeconomics with television coverage of a sports event.**
Microeconomics focuses on how individual households and firms make choices, how they interact in markets, and how the government attempts to influence their choices. This focus is similar to that of a sideline camera at a football game.

Step 3: **Compare the focus of macroeconomics with the television coverage of a sports event.**
Macroeconomics is the study of the economy as a whole, including topics such as inflation, unemployment, and economic growth. Macroeconomics does not study the decisions made by individuals but the consequences of actions taken by all decision makers in an economy. This is similar to the blimp's aerial view of the venue where a sports event occurs. One can see the entire venue, but the blimp's point of view is too far away to see any individual player or fan.

Extra Analyze the Concept

Macroeconomic and Microeconomic Analysis

Economists separate the study of how households and firms make choices and interact in markets (microeconomics) from the study of the economy as a whole (macroeconomics). But some issues can be viewed from both perspectives. Labor productivity is one such issue.

Labor productivity—the quantity of goods and services that can be produced by one worker or by one hour of work—is a microeconomic topic. Labor productivity increases when a firm invests in capital or experiences an improvement in technology. Increased labor productivity allows a firm to earn higher profits

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and pay its workers higher wages. But macroeconomists also study labor productivity because it determines the standard of living a country can achieve for its citizens. An increase in productivity is beneficial in the long run, but it can slow the growth of jobs in the short run. Following the recessions of 2001 and 2007–2009, many economists were concerned that the unemployment rate did not decrease as quickly as it did following previous recessions. One reason for this was an increase in productivity. The Bureau of Labor Statistics reported that output per hour worked of all persons rose by over 3 percent in both 2009 and 2010. Because workers were more productive, firms did not have to hire new workers to produce the same amount of goods and services. Productivity growth slowed to about 1 percent or less from 2011 to 2014.

Some economists attribute the slowdown in productivity growth to a decline in investments in research by U.S. firms from the high levels reached after 1995, which resulted in advancements in computer-related applications. Other economists claim that many recent improvements in productivity escape measurement. Google Inc.'s chief economist Hal Varian has argued that many innovations—such as apps that can be used via cell phones to track locations or hailing taxis—lead to improvements in productivity "But I doubt that gets measured anywhere."

Sources: Department of Labor (Bureau of Labor Statistics); and Timothy Aeppel, "Silicon Valley Doesn't Believe U.S. Productivity Is Down," *Wall Street Journal*, July 16, 2015.

1.5 Economic Skills and Economics as a Career (pages 16–17)

Learning Objective: Describe economics as a career and the key skills you can gain from studying economics.

Economists describe how individuals, businesses and governments make choices and analyze the results of these choices. Many businesses, government agencies and non-profit organizations hire economists. Students who consider whether to pursue a career in economics may seek an internship with a firm or agency that employs economists.

1.6 A Preview of Important Economic Terms (pages 17–19)

Learning Objective: Define important economic terms.

This section provides a brief definition and preview of terms students will see throughout the book: firm (company, or business), entrepreneur, innovation, technology, goods, services, revenue, profit, household, factors of production (economic resources or inputs), capital, and human capital.

Extra Economics in Your Life and Career:
Is Cheating a Rational Decision?

In their best-selling book *Freakonomics*, Steven D. Levitt and Stephen J. Dubner stated: "Who cheats? Well, just about anyone, if the stakes are right…Cheating…is a prominent feature in just about every human endeavor." Evidence that *some* people cheat surfaced in the summer of 2011 when the superintendent of the board of the Atlanta school district resigned after a report documented widespread cheating on standardized tests that implicated officials from about 80 percent of Atlanta's elementary and middle schools. In 2015, an Atlanta jury convicted 11 teachers as a result of the cheating scandal.

Steven Levitt and other economists assume that decision-makers—students and non-students alike—are rational. They compare the benefits and costs of their options and make choices for which the expected benefits exceed the expected costs. The benefits of (successful) cheating may be monetary; for example,

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K-12 teachers in some states are eligible for bonus payments of up to $25,000 if their students perform well on standardized tests. New technology has made it easier for high school and college students to cheat. The widespread use of cell phones and Internet access makes it easier (less costly) to share exam answers and buy term papers.

Sources: Steven D. Levitt and Stephen J. Dubner, *Freakonomics* New York: HarperCollins 2005, pages 24–25; Patrik Jonsson, "America's biggest teacher and principal cheating scandal unfolds in Atlanta," *Christian Science Monitor*, July 5, 2011; Mary Beth McCauley, "Atlanta school cheating: When teachers cheat, what do you tell the kids?" *Christian Science Monitor*, September 5, 2013; and Valerie Strauss, "How and Why Convicted Teachers Cheated on Standardized Tests," *Washington Post*, April 1, 2015.

Question: For the sake of argument, let's assume that you would never cheat. Under what circumstances are students in general more or less likely to cheat on an economics examination?

Answer: Your economics instructor will be pleased if you would never cheat under any circumstances. But cheating is more likely when: (a) the positive consequences of receiving a high grade are significant (for example, a high grade is necessary to maintain a scholarship, gain admittance to medical school, or get a good job offer), and/or (b) the probability of getting caught is low (the instructor gives the same multiple-choice exam to all students in a large classroom with no supervision). Reducing the benefit and increasing the cost of getting caught will reduce the incidence of cheating. If appeals to personal integrity are not enough to convince students not to cheat, a more effective deterrent may be for potential employers to let students know that they fire dishonest employees.

Appendix

Using Graphs and Formulas (pages 27–39)

Learning Objective: Use graphs and formulas to analyze economic situations.

Graphs simplify economic ideas and make the ideas more concrete so they can be applied to real-world problems.

Graphs of One Variable

Figure 1A.1 in the textbook displays examples of two common types of graphs: bar graphs and pie charts. The height of the bars in the bar graph represents the market shares of automobile firms. The pie chart shows the same information with the market shares of each group of firms represented by the size of its slice of the pie. Information on economic variables can also be displayed in time-series graphs. These graphs are displayed on a coordinate grid. The vertical axis (y-axis) of a coordinate grid measures the value of one variable. The point where the vertical axis intersects the horizontal axis is the origin. The horizontal axis of a coordinate grid measures the value of another variable. The points in a coordinate grid represent the values of the two variables. Figure 1A.2 illustrates examples of time-series graphs.

Graphs of Two Variables

We often use graphs to show the relationship between two variables. Figure 1A.3 illustrates the graph of a linear or straight-line demand curve where price is measured along the vertical axis and quantity is measured along the horizontal axis.

A. Slopes of Lines

The slope of a straight line indicates how much the variable measured along the y-axis changes as the variable measured along the x-axis changes. Slope can be measured between any two points on the line because the slope of a straight line has a constant value. The slope can be expressed as the change in the

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value measured on the vertical axis divided by the change in the value measured on the horizontal axis; slope can also be expressed using the Greek letter delta (Δ) to stand for the change in a variable (slope = $\Delta y/\Delta x$). The slope is also referred to as the rise divided by the run.

$$\text{Slope} = \frac{\text{Change in value on the vertical axis}}{\text{Change in the value on the horizontal axis}} = \frac{\Delta y}{\Delta x} = \frac{\text{Rise}}{\text{Run}}$$

Taking into Account More Than Two Variables on a Graph

The demand curve in Figure 1A.4 shows the relationship between the price of pizza and the quantity of pizza sold, but the quantity of any good sold depends on more than just the price of the good. Allowing other variables to change will cause the position of the demand curve in the graph to change. The table in Figure 1A.5 shows the effect of a change in the price of hamburgers on the quantity of pizza demanded. By shifting the demand curve, we take into account the effect of changes in a third variable.

A. Positive and Negative Relationships

Sometimes the relationship between two variables is negative, as in the case with the price of pizza and the quantity of pizza demanded. The relationship between two variables can be positive, as in Figure 1A.6 which shows values for disposable personal income and consumption spending in the United States for 2015–2018.

B. Determining Cause and Effect

Inferring cause and effect relationships by observing graphs can lead to incorrect conclusions. One reason for this is that there may be an omitted variable that is not accounted for in the graph. A related problem in determining cause and effect is reverse causality; this occurs when we conclude that changes in variable *X* cause changes in variable *Y,* when changes in variable *Y* cause changes in variable *X.*

C. Are Graphs of Economic Relationships Always Straight Lines?

The relationship between two variables is linear when it can be represented by a straight line. Few economic relationships are actually linear. However, it is often useful to approximate a nonlinear relationship with a linear relationship.

D. Slopes of Nonlinear Curves

To measure the slope of a nonlinear curve at a particular point we must measure the slope of a tangent to the curve at that point. A tangent line touches the curve at only one point. The slope of a tangent is measured in the same way as the slope of any straight line.

Formulas

A. Formula for a Percentage Change

The formula for a percentage change between two variables for any two periods is:

$$\text{Percentage change} = \frac{\text{Value in the second period} - \text{Value in the first period}}{\text{Value in the first period}} \times 100$$

B. Formulas for the Areas of a Rectangle and a Triangle

The formula for the area of a rectangle is Base × Height. The formula for the area of a triangle is ½ × Base × Height.

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C. Summary of Using Formulas

Follow these steps when using a formula:

1. Make sure you understand the economic concept the formula represents.
2. Make sure you are using the correct formula for the problem you are solving.
3. Make sure the number you calculate using the formula is economically reasonable.

Teaching Tips

You can assign the appendix as "on your own" reading. But don't assume students will understand the formulas for computing a slope or a percentage change. Reviewing these formulas in class will be time well spent, either at this point in the course or when these formulas are first applied. In particular, students will need to use graphs of two variables and percentage changes often throughout the remainder of the text.

Solutions to End-of-Chapter Exercises

Answers to *Thinking Critically* Questions

1. A tariff is a tax on imports. When a 25 percent tariff is imposed on imports from China, U.S. firms that import goods from China must pay the U.S. government an amount equal to 25 percent of the price of the imported goods. These U.S. firms will likely have to increase the price they sell the imported Chinese-made goods for, which will reduce the sales of the goods in the United States. If these products were manufactured in the United States, then, of course there would be no tariff. The imposition of the tariff would therefore become an economic incentive for U.S. companies to return manufacturing jobs from China to the United States. For some firms, the incentive might not be enough to offset other cost advantages from producing goods in China.

2. Positive analysis is concerned with *what is*, while normative analysis is concerned with *what ought to be*. Positive economic analysis of the statement could show (1) whether the tariffs are actually increasing the number of manufacturing jobs in the United States or whether other factors are also responsible for some of the job creation, and (2) whether increasing the tariffs would likely continue to increase the number of manufacturing jobs and whether those increases would cause other job losses (for example, if the tariffs resulted in a company like Apple having to charge higher prices for smartphones and therefore hire fewer workers in the United States). In other words, the tariffs could result in both winners and losers in terms of domestic employment.

Should the gains to the winners from increasing tariffs be valued more than the losses to the losers? The answer to this question involves normative analysis. Positive analysis can show the consequences of a particular policy such as implementing tariffs, but positive analysis cannot determine whether such a policy is a "good" or "bad" idea. Whether you agree or disagree with the statement, you are making a value judgment or a normative statement rather than drawing a conclusion from positive analysis.

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1.1 Three Key Economic Ideas

Learning Objective: Explain these three key economic ideas: People are rational, people respond to economic incentives, and optimal decisions are made at the margin.

Review Questions

1.1 "People are rational" is the assumption that decision makers explicitly or implicitly weigh the benefits and costs of each action and then choose an action only if the benefits are expected to outweigh the costs. "People respond to economic incentives" by changing their behavior in response to an economic incentive. For example, if the federal government begins to tax firms an amount equal to government benefits their low-wage employees receive, firms are likely to hire fewer low-wage workers. "Optimal decisions are made at the margin" means that most decisions are not "all or nothing," but involve doing a little more or a little less of an activity. Therefore, the optimal decision is to continue any activity up to the point where the marginal benefit equals the marginal cost.

1.2 Scarcity is the situation in which unlimited wants exceed the limited resources available to fulfill those wants. Economics is the study of the choices consumers, business managers, and government officials make to attain their goals. Scarcity is central to economics because scarcity requires people to make choices about how to use their resources to best fulfill their wants. In making choices, we must give up other opportunities that we value. What we give up (our second-best choice) is called the opportunity cost of our choice.

Problems and Applications

1.3 Economists assume that people are rational in the sense that they use all available information as they act to achieve their goals. Rational individuals weigh the benefits and costs of each action, and they choose an action only if the benefits outweigh the costs. Economists do not assume everyone is a genius or always makes the "right" decision in every circumstance; rather, economists assume that the actions of consumers and businesses reflect their attempts to achieve their goals.

1.4 We need information on the losses the typical bank suffers from a robbery and the cost of installing a bandit barrier or taking other actions, such as hiring a guard, to deter a robbery. The cost of installing a bandit barrier would include the cost of potentially losing customers who find bandit barriers off-putting. The fact that not many banks install bandit barriers indicates that these banks have found that the marginal cost of adding the additional security is greater than the expected marginal benefit from reducing the expected number of robberies.

1.5 **a**. Students face a scarcity of time, like everyone else, and respond to the incentives of the teacher's grading system. Students have more incentive to put their efforts into the parts of the course that have the most weight in the grading system.

b. If teachers put too little weight in the grading scale on outside readings, or similar assignments, students will have little incentive to read and master the material. Students will put less effort into the parts of the course that have little effect on their grades.

c. Quizzes on assigned readings would give students an incentive to come to class having read the upcoming material. Some teachers give preparation assignments where students have to read and answer questions about the upcoming material, and over the course of the semester students have to successfully complete a certain percentage of the preparation assignments to qualify for an A, B, or other grade in the course.

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1.6 **a.** As a result of changes in the federal student loan programs the total amount students borrow should increase. The changes increase the incentive students have to borrow money under the programs because they limit the amount of the loans that must be repaid.

b. If in 2016 President Obama was recommending further changes to the student loan program, then it's likely that the 2011 changes to the program had results that were not expected. The most likely unexpected result is that because the 2011 changes required students to pay back less, students were borrowing more money than the president and his advisers had anticipated. So, in 2016, it's likely that President Obama recommended changes that would increase the loan repayments borrowers would have to make.

c. President Obama and his advisers may have failed to take into account that the 2011 changes to the program changed the incentives students faced. Because the incentive to increase the amount borrowed increased, President Obama and his advisers underestimated the increase in the amount the federal government would have to pay in loan subsidies.

1.7 **a.** Employees who have health problems incur higher medical costs than healthier employees. The higher medical costs increase the health insurance premiums that firms must pay for employer-provided health insurance, which raises the firms' costs. These higher costs provide an incentive for universities and corporations to encourage employees to improve and maintain their health.

b. Health insurance decreases the incentive of employees to improve or maintain their health, because employees with health insurance do not pay the full cost of their medical bills.

c. A wellness program, if successful, would decrease the premiums that an insurance company would charge. Healthier employees would have fewer health problems that would be covered by a university's or a corporation's insurance plan.

1.8 **a.** As stated in the text, under the act, firms whose employees received assistance from government benefits, including Medicaid and the Supplemental Nutrition Assistance Program (SNAP), would be required to pay a tax equal to cost of the assistance.

b. Firms that might otherwise have hired a low-wage worker may now be reluctant to do so because the firms could be liable for paying the tax. In effect, the act would raise the cost of employing low-income workers who receive government benefits.

c. The sponsors of the legislation may have hoped that firms would raise the wages of low-income workers, which would make it unnecessary for these workers to apply for government benefits. The sponsors may also have intended to call attention to the low wages being paid to some workers and may not have expected that the act would actually become law.

1.9 By "incremental revenue" and "incremental cost," the author means marginal revenue and marginal cost. "Incremental" means the same thing as "marginal." The USPS's total cost includes such things as the cost of purchasing delivery trucks and the cost of maintaining post office buildings and warehouses that are not affected by the number of packages that the USPS delivers. In determining whether delivering packages for Amazon will increase its overall profit or reduce its overall loss, the USPS should look only at the marginal (or incremental or additional) revenue and marginal cost of delivering packages for Amazon. If the marginal revenue exceeds the marginal cost, the USPS's profit will increase (or its loss will decrease). If the marginal cost exceeds the marginal revenue, the USPS's profit will decrease (or its loss will increase).

1.10 Your friend is failing to think at the margin. It doesn't matter how much time your friend has already spent studying psychology. What matters is the marginal benefit to be received from

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studying psychology relative to the marginal cost, where cost is the opportunity cost of lower grades in other subjects. If the course is required, that may raise the marginal benefit.

1.11 A complete explanation for the connection between majoring in economics and success in business would involve many factors. But we can say that economics teaches us how to look at the trade-offs involved in every decision we make. Those who do not make decisions by weighing the costs of an action against its benefits are unlikely to make good decisions. Climbing the corporate or governmental ladder requires making a wider and wider array of decisions.

1.2 The Economic Problem That Every Society Must Solve

Learning Objective: Discuss how an economy answers these questions: What goods and services will be produced? How will the goods and services be produced? Who will receive the goods and services produced?

Review Questions

2.1 Scarcity implies that every society and every individual faces trade-offs because wants are unlimited but the ability to satisfy those wants is limited. Societies and individuals cannot have everything they want, so they have to make choices of what to have and what not to have.

2.2 The three economic questions that every society must answer are (1) What goods and services will be produced? (2) How will the goods and services be produced? (3) Who will receive the goods and services produced? In a centrally planned economy, the government makes most of these decisions. In a pure market economy, almost all of these decisions are made by the decentralized interaction of households and firms in markets. In a mixed economy, most economic decisions result from the interaction of buyers and sellers in markets, but government may play a significant role in the allocation of resources.

2.3 Productive efficiency occurs when a good or service is produced at the lowest possible cost. Allocative efficiency means that what is produced reflects consumer preferences—every good or service is produced up to the point at which the last unit provides a marginal benefit to consumers equal to the marginal cost of producing it.

2.4 Efficiency is concerned with producing the goods and services that people want at the lowest cost. Equity is "fairness," a concept that can differ from person to person. Government policymakers often want to make economic outcomes "fairer," but doing so usually involves redistributing income from one group to another. Redistributing income often (but not always) hampers efficiency because it reduces incentives to produce and drives up production costs.

Problems and Applications

2.5 Yes, even Jeff Bezos faces scarcity because his wants exceed his resources. Bezos has established a foundation to help homeless families and to establish pre-schools in low-income areas. There are an unlimited number of other worthy causes that Bezos could fund, so even he faces scarcity. Further, even Bezos has only 24 hours in a day, so he must make choices about how to spend his scarce time. Everyone faces scarcity because human desires are virtually unlimited. Your resources are limited, so the only way not to face scarcity would be to reduce your wants to be no greater than your resources—not something that most people are capable of doing!

2.6 Spending resources in a way that helps only one poor person is likely to be an ineffective way of helping poor people. How many poor people could be helped by using another method of helping

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the poor? The opportunity cost of using one method is the number of poor people that could be helped by using the best available alternative method.

2.7 Although many factors that affect the opportunity cost of attending college football games have changed over time, some of the most significant changes during the past decade involve technology. For example, more games are televised, games can be viewed online with enhanced features, and alternative sources of entertainment, such as streaming television shows and movies or interacting with friends on social media, have also become available. These changes increase the opportunity cost of watching football games in person and help to explain the decline in attendance over time.

2.8 Allocative efficiency occurs when production is in accordance with consumer preferences. Productive efficiency occurs when a good or service is produced at the lowest possible cost. Profit is the incentive for a firm in a market economy to be allocatively efficient and productively efficient. If a firm is not allocatively efficient and productively efficient, then it will eventually suffer losses and go out of business.

2.9 Productive efficiency refers to a situation in which a good or service is produced at the lowest possible cost. Allocative efficiency is a state in which production is in accordance with consumer preferences: Every good or service is produced up to the point where the last unit provides a marginal benefit to society equal to the marginal cost of producing it. The test that Alberto Chong and his colleagues carried out was not designed to measure how much it would cost to send and return letters in various countries, but how often–and how quickly–the letters sent were returned. Each envelope mailed contained one page to limit the possibility that curious postal employees would be tempted to open the envelope to steal the contents. Written on each envelope was a request to "please return to sender if undeliverable." Therefore, it was likely that the letter would either be returned or discarded. Because the experiment was testing which postal services were best at properly handling consumers' letters, it is better viewed as an evaluation of allocative efficiency rather than productive efficiency.

2.10 Although the federal government's Food and Drug Administration (FDA) must approve a drug or medical device before it is offered for sale, privately owned firms produce and sell these products. It would be more accurate to view markets for drugs and medical devices as characteristic of a mixed economy: an economy in which most economic decisions result from the interaction of buyers and sellers in markets but one in which the government plays a significant role in the allocation of resources.

2.11 As discussed in the chapter, equity, or the fair distribution of benefits, can be difficult to define. For some people, equity means a more *equal* distribution of income than would result from an emphasis on efficiency alone. Raising taxes on people with higher incomes to provide the funds for programs that aid the poor might increase equity, but may reduce the economic incentive to work hard, start new businesses, and save. Reducing these activities will reduce economic efficiency, which illustrates the trade-off between equality and efficiency. An economist can write an entire book on the subject because equality can be difficult to define and because it can be difficult to measure the extent to which efforts to promote equality can reduce efficiency. The trade-off involves complicated normative and positive issues.

2.12 If all of an economic system's resources were devoted to providing health care, there would be other important goods and services, such as food, housing, clothing, and education that the economy could not provide. An economic system that provided its citizens with state-of-the-art health care but so little food that most were on the verge of starvation, no housing so that many were sleeping in streets and fields, and no schooling so most people were illiterate, would generally be regarded as inefficient and treating the population unfairly by depriving them of such important goods and services. A market economy restricts access to health care, just as it restricts access to

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all goods and services, by charging a price at which less than an unlimited quantity of health care is demanded.

2.13 **a.** The groups of students most likely to get the tickets will be those for whom the expected marginal benefit of going to the athletic department office on Monday morning is greater than the expected marginal cost. These would include students who have a relatively low opportunity cost of their time, such as those who have no Monday morning classes. Other students who are likely to stand in line are those who would have a large benefit from having the tickets: Those who love football and those who hope to sell their tickets ("scalpers").

b. The major opportunity cost of distributing the tickets this way is the cost to those students who attempt to get the tickets, such as: The activities the students can't do while standing in line, and the costs to students who stand in line but find that all the tickets are sold before their turn comes. There's also the cost of the lost revenue to the college from giving away the tickets instead of selling them.

c. This isn't an efficient way to distribute the tickets because of the high cost in wasted time. It would be more efficient to sell the tickets to those willing to pay the highest prices

d. Equity is hard to define. Some people will see this way of distributing tickets as equitable because students with low incomes can still get tickets, provided they are willing to pay the opportunity cost of waiting in line. Some people will see this way of distributing the tickets as equitable because only those with the greatest desire to watch the game in person will put up with the hassle of getting the tickets. Some people might argue that this system is equitable because students are more deserving than nonstudent recipients of the tickets. Others may disagree, saying that students with a strong desire to obtain the tickets, but who are unable to be at the athletic department office at the designated time, would have no chance to get the tickets. Still others could argue that the system was not equitable because this way of distributing tickets generates no revenue for the athletic department, which could use the revenue to cover some of the costs of administering the college's athletic programs.

1.3 Economic Models

Learning Objective: Explain how economists use models to analyze economic events and government policies.

Review Questions

3.1 Economists use models for the same reason that other scientists do—to make a complicated world simple enough that problems can be understood and analyzed and questions can be accurately answered. Useful models will generate testable predictions. If these predictions are consistent with economic data, the model isn't rejected and can be used to understand the economy. Testing models with data can be very difficult, however, because the economy is always changing, and it is difficult to conduct controlled economic experiments.

3.2 Economists can create a useful model by following these five steps: (1) decide the assumptions to be used; (2) formulate a testable hypothesis; (3) use economic data to test the hypothesis; (4) revise the model if it fails to explain the economic data well; and (5) retain the revised model to help answer similar economic questions in the future.

3.3 Positive economic analysis is concerned with what *is*; that is, it deals with how the economy actually behaves. Normative economic analysis is concerned with what *ought to be*. Economics is

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mainly concerned with positive analysis—conceptualizing and measuring the costs and benefits of different courses of action. Decision makers, including voters and government officials, can use the trade-offs and costs and benefits identified by positive economic analysis to normatively decide what course of action they should take.

Problems and Applications

3.4 The economist should revise the model in light of its failure to explain or predict real world events.

3.5 The problem with Dr. Strangelove's theory is that it cannot be tested unless we can devise a way to measure the emission of these subatomic particles, which is impossible because such testing methods don't exist. Because we cannot test the model's predictions, we have no way of knowing if the theory might be true; therefore, the theory is not very useful.

3.6 **a.** This statement represents positive analysis, analysis concerned with "what is." Positive analysis would use an economic model to measure the effect a tax on cigarettes has on teenagers' purchases of cigarettes.

b. This statement represents normative analysis, analysis concerned with "what ought to be." Whether the federal government should or should not spend more on research to reduce opioid addiction cannot be determined based on positive analysis alone, but requires a normative judgment, or opinion.

c. This statement represents positive analysis. This statement can be tested to determine whether it is correct.

d. This statement represents normative analysis because it is an opinion or belief that the price of Starbucks coffee is too high.

3.7 Lowery is making a normative judgment regarding the policy: She believes that the federal government should guarantee everyone financial security. Normative analysis concerns what one person believes ought to be. You can agree or disagree with her opinion depending on your own views of the issue. There is no way to demonstrate that Lowery's opinion is correct.

3.8 To evaluate the positive elements of this debate, it would be useful to have statistics on the effect similar import tariffs on other goods have had on sales of those imported goods and on employment in import-competing firms. It would also be useful to have forecasts of the likely effect a tariff imposed on imports from China would have on the prices of those goods in the United States and on employment in the U.S. industries that produce goods that compete with Chinese imports. Even if this information were available, it is unlikely that the normative issues involved in the debate would be resolved. People differ on how they evaluate the benefits of saving jobs in a domestic industry that would be protected by tariffs relative to the cost of the higher prices domestic consumers will have to pay because of the tariffs.

3.9 **a.** A tariff on imported steel will raise the prices of those imports making it likely that some U.S. consumers of steel, such as U.S. automobile firms, will shift from buying imported steel to buying domestically produced steel. In addition, domestic steel firms, like U.S. Steel, will be able to raise prices, which will also likely increase their profits.

b. **i.** The tariff will hurt U.S. automobile firms because steel is an input in the production of automobiles.

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ii. The tariff will hurt U.S. consumers because they will have to pay higher prices for goods, such as automobiles and washing machines, that use steel as an input.

iii. The tariff will likely help workers at U.S. steel firms because sales of domestic steel will likely increase, increasing employment at domestic steel firms. In addition, steel firms may become more profitable and steel workers may be able to negotiate for higher wages.

iv. If the tariff increases the profits of U.S. steel firms, the value of these firms may increase, which will help people who invested in these firms.

c. People who benefitted from tariffs are likely to support them. We can't say those people will *necessarily* support tariffs, though, because their support for free trade unrestricted by tariffs may supersede their monetary gains from a particular tariff. The people who are hurt by the tariffs are likely to oppose them, but we can't say they will *necessarily* oppose them for two reasons: 1) Some of the people who lose from tariffs may not understand that tariffs inflicted losses on them. For example, a consumer who pays more for a washing machine may not understand that the price of the washing machine has increased because of the steel tariffs; 2) Some people who are hurt by the tariffs may still support them because, for example, they believe it is a good idea, on normative grounds, to protect jobs in the steel industry.

3.10 An economic model used to forecast the number of employees in manufacturing industries in 2026 should take account of the expected growth of manufactured goods during this time period. The model should also account for the effect of technology on manufacturing because new technology, including the use of robotics, will affect the number of workers firms will hire. The model should account for possible changes in economic policy enacted by the government, but estimates of the effects will be imprecise because Congress and the president must agree on some policy proposals before they become law and the outcome of that political process is uncertain.

3.11 **a.** The system helps protect consumers by providing high-quality training for physicians.

b. This system allows physicians in a specialty to limit the number of physicians in that specialty. Increasing the number of physicians in a specialty is likely to reduce the incomes physicians earn.

c. Occupational licensing, such as licensing doctors, is an important topic in economics. While the licensing requirements—in this case the control of the size of residency programs—help ensure high-quality training for physicians, they also are in the self-interest of physicians because the requirements help maintain physicians' salaries. Given this trade-off, whether it is a good system is a normative question.

1.4 Microeconomics and Macroeconomics

Learning Objective: Distinguish between microeconomics and macroeconomics.

Review Question

4.1 Microeconomics is the study of how households and firms make choices, how they interact in specific markets, and how the government influences their choices. "Micro" means small, and microeconomics deals with individual decision makers. Macroeconomics is the study of the economy as a whole. "Macro" means large, and macroeconomics deals with economy-wide outcomes, such as the inflation rate, the unemployment rate, and the economic growth rate.

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4.2 No, because many economic situations have both a microeconomic and a macroeconomic component. For example, the level of total consumption spending by households helps to determine how fast the economy grows—which is a macroeconomic issue. But to understand the amount of consumption spending by households, we have to analyze the incentives and constraints individual households face—this is a microeconomic issue.

Problems and Applications

4.3 a. and d. are microeconomic questions because they relate to specific industries.

b. and c. are macroeconomic questions because they relate to economy-wide issues.

4.4 You should disagree with the assertion. Microeconomics deals with individual decision makers. Because the unemployment rate in any one city would be an issue for the economy of the entire city and not an individual, it is a macroeconomic issue rather than a microeconomic issue. The effect on teen smoking of an increase in the tax on cigarettes is better thought of as a microeconomic issue because it depends on the reactions of individuals to the increase in the tax.

Suggestions for the *Thinking Critically Exercises*

CT1.1 Answers to this question will vary substantially and will depend upon the background of the student. The main point is not correctness, but to help students connect the chapter to their prior knowledge. Whether students' responses accomplish this goal is difficult for an instructor to evaluate. Finally, by connecting to their prior knowledge, students should learn this topic more deeply.

CT1.2 The key here is what incentive do you need to select to encourage you to train? Also, keep in mind that this question suggests that one is training now so it is also about additional training, or marginal analysis.

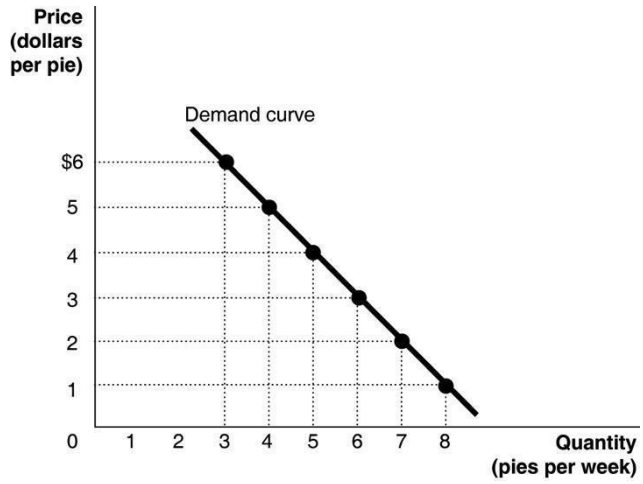
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Solutions to Chapter 1 Appendix

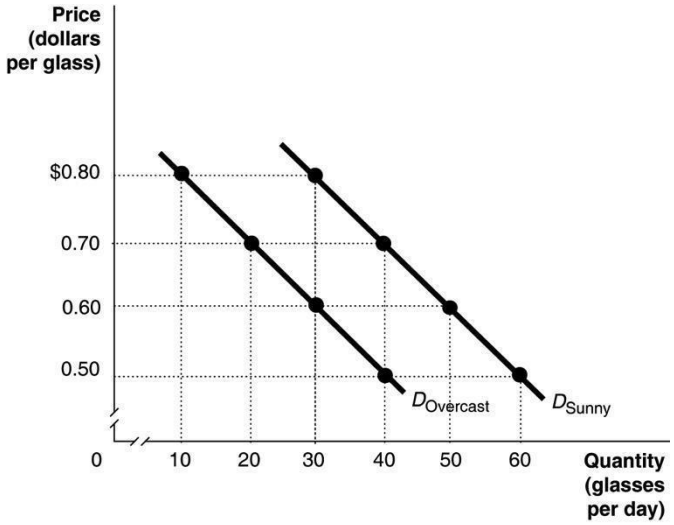
1A.1 **a.** The relationship is negative because as price decreases, the quantity of pies purchased increases.

b.



c. The slope = $\Delta y/\Delta x$ = rise/run = –1/1 = –1.

1A.2



1A.3

Year	Percentage Change
2007	[(6.6 – 6.6)/6.6] × 100 = 0.0%
2008	[(5.4 – 6.6)/6.6] × 100 = −18.2%
2009	[(4.9 – 5.4)/5.4] × 100 = − 9.3%
2010	[(5.5 – 4.9)/4.9] × 100 = 12.2%
2011	[(5.7 – 5.5)/5.5] × 100 = 3.6%
2012	[(5.7 – 5.7)/5.7] × 100 = 0.0%
2013	[(6.3 – 5.7)/5.7] × 100 = 10.5%

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2014 [(6.3 – 6.3)/6.3] × 100 = 0.0%
2015 [(6.7 – 6.3)/6.3] × 100 = 6.3%
2016 [(6.7 – 6.7)/6.7] × 100 = 0.0%
2017 [(6.6 − 6.7)/5.7] × 100 = −1.5%
2018 [(6.0 − 6.6)/6.6] × 100 = −9.1%

We can conclude that sales fell at the highest rate in 2008.

1A.4 [($18,051 billion − $17,659 billion)/$17,659 billion] × 100 = 2.2%

The percentage change in real GDP from one year to the next is the economy's growth rate.

1A.5 **a.**



b. At $2.50, the total revenue equals rectangles $A + B$ = $250,000 (because $2.50 × 100,000 = $250,000). At $1.25, the total revenue equals rectangles $B + C$ = $250,000 (because $1.25 × 200,000 = $250,000).

1A.6 The triangle's area = (0.5) × (175,000 – 115,000) × ($2.25 − $1.50) = 0.5 × 60,000 × $0.75 = $22,500.

1A.7 The slope is calculated using the formula:

$$\text{Slope} = \frac{\text{Change in value on the vertical axis}}{\text{Change in value on the horizontal axis}} = \frac{\Delta y}{\Delta x} = \frac{\text{Rise}}{\text{Run}}.$$

At point *A*: rise = 300 − 175 = 125, run = 7 − 5 = 2. Therefore, the slope = 125/2 = 62.5.

At point *B*: rise = 900 − 700 = 200, run = 14 – 12 = 2. Therefore, the slope = 200/2 = 100.

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CHAPTER 2 | Trade-offs, Comparative Advantage, and the Market System

Brief Chapter Summary and Learning Objectives

2.1 Production Possibilities Frontiers and Opportunity Costs (pages 42–47)

Use a production possibilities frontier to analyze opportunity costs and trade-offs.

- The model of the production possibilities frontier is used to analyze the opportunity costs and trade-offs that individuals, firms, and countries face.

2.2 Comparative Advantage and Trade (pages 47–54)

Describe comparative advantage and explain how it serves as the basis for trade.

- Comparative advantage is the ability of an individual, firm, or country to produce a good or service at a lower opportunity cost than other producers.

2.3 The Market System (pages 54–63)

Explain the basics of how a market system works.

- Markets enable buyers and sellers of goods and services to come together to trade.

Key Terms

Absolute advantage, p. 50. The ability of an individual, a firm, or a country to produce more of a good or service than competitors, using the same amount of resources.

Circular-flow diagram, p. 55. A model that illustrates how participants in markets are linked.

Comparative advantage, p. 50. The ability of an individual, a firm, or a country to produce a good or service at a lower opportunity cost than competitors.

Economic growth, p. 47. The ability of an economy to produce increasing quantities of goods and services.

Entrepreneur, p. 59. Someone who operates a business, bringing together the factors of production—labor, capital, and natural resources—to produce goods or services.

Factor market, p. 54. A market for the factors of production, such as labor, capital, natural resources, and entrepreneurial ability.

Factors of production, p. 54. Labor, capital, natural resources, and other inputs used to make goods and services.

Free Market, p. 56. A market with few government restrictions on how a good or service can be produced or sold or on how a factor of production can be employed.

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Market, p. 54. A group of buyers and sellers of a good or service and the institution or arrangement by which they come together to trade.

Opportunity cost, p. 43. The highest-valued alternative that must be given up to engage in an activity.

Product market, p. 54. A market for goods—such as computers—or services—such as medical treatment.

Production possibilities frontier (*PPF*), p. 42. A curve showing the maximum attainable combinations of two goods that can be produced with available resources and current technology.

Property rights, p. 60. The rights individuals or businesses have to the exclusive use of their property, including the right to buy or sell it.

Scarcity, p. 42. A situation in which unlimited wants exceed the limited resources available to fulfill those wants.

Trade, p. 47. The act of buying and selling.

Chapter Outline

Elon Musk and Tesla Motors Face a Trade-Off

In 2019, Elon Musk, founder of Tesla Motors, hoped to sell his Model 3 automobile for $35,000. But the resources required to bring down the cost of the Model 3 would have to be taken from the manufacture of Tesla's Model X sports utility vehicle and Model S sedan, each of which were more profitable and more expensive than the Model 3. As Tesla dealt with the trade-offs involved in allocating resources among its models, the federal government was phasing out a $7,500 subsidy on the purchase of an electric car. The federal government faced its own trade-off: The tax revenue it gives up as a result of the tax credit isn't available to fund other programs.

2.1 Production Possibilities Frontiers and Opportunity Costs (pages 42–47)

Learning Objective: Use a production possibilities frontier to analyze opportunity costs and trade-offs.

Scarcity is a situation in which unlimited wants exceed the limited resources available to fulfill those wants. Goods and services are scarce, as are the resources used to make goods and services.

A **production possibilities frontier (*PPF*)** is a curve showing the maximum attainable combinations of two goods that can be produced with available resources and current technology.

A. Graphing the Production Possibilities Frontier

All combinations of products on a production possibilities frontier are efficient because all available resources are being used. Combinations inside the frontier are inefficient because maximum output is not obtained from available resources. Points outside the frontier are unattainable given the firm's current resources. **Opportunity cost** is the highest-valued alternative that must be given up to engage in an activity.

B. Increasing Marginal Opportunity Costs

A production possibilities frontier that is bowed outward illustrates increasing marginal opportunity costs, which occur because some workers, machines, and other resources are better suited to one use than to

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another. Increasing marginal opportunity costs illustrate an important concept: The more resources already devoted to any activity, the smaller the payoff to devoting additional resources to that activity.

C. Economic Growth

Economic growth is the ability of an economy to produce increasing quantities of goods and services. Economic growth can occur if more resources become available or if a technological advance makes resources more productive. Growth may lead to greater increases in production for one good than another.

2.2 Comparative Advantage and Trade (pages 47–54)

Learning Objective: Describe comparative advantage and explain how it serves as the basis for trade.

Trade is the act of buying and selling. Trade makes it possible for people to become better off by increasing both their production and their consumption.

A. Specialization and Gains from Trade

*PPF*s show the combinations of two goods that can be produced if no trade occurs. We can also use *PPF*s to show how someone can benefit from trade even if she is better than someone else at producing both goods.

B. Absolute Advantage versus Comparative Advantage

Absolute advantage is the ability of an individual, a firm, or a country to produce more of a good or service than competitors, using the same amount of resources. If the two individuals have different opportunity costs for producing two goods, each individual will have a comparative advantage in the production of one of the goods. **Comparative advantage** is the ability of an individual, a firm, or a country to produce a good or service at a lower opportunity cost than competitors. Comparing the possible combinations of production and consumption before and after specialization and trade occur proves that trade is mutually beneficial.

C. Comparative Advantage and the Gains from Trade

The basis for trade is comparative advantage, not absolute advantage. Individuals, firms, and countries are better off if they specialize in producing the goods and services for which they have a comparative advantage and obtain the other goods and services they need by trading.

Teaching Tips

An example of comparative advantage is the career of baseball legend Babe Ruth. Before he achieved his greatest fame as a home run hitter and outfielder with the New York Yankees, Ruth was a star pitcher with the Boston Red Sox. Ruth may have been the best left-handed pitcher in the American League during his years with Boston (1914–1919), but he was used more as an outfielder in his last two years with the team. In fact, he established a record for home runs in a season (29) in 1919. The Yankees acquired Ruth in 1920 and made him a full-time outfielder. The opportunity cost of this decision for the Yankees was the wins he could have earned as a pitcher. But because New York already had skilled pitchers, the opportunity cost of replacing him as a pitcher was lower than the cost of replacing Ruth as a hitter. No one else on the Yankees could have hit 54 home runs, Ruth's total in 1920; the next highest total on the Yankees was 11. It can be argued that Ruth had an absolute advantage as both a hitter and pitcher for the Yankees in 1920, but a comparative advantage only as a hitter.

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2.3 The Market System (pages 54–63)

Learning Objective: Explain the basics of how a market system works.

In the United States and most other countries, trade is carried out in markets. A **market** is a group of buyers and sellers of a good or service and the institution or arrangement by which they come together to trade. A **product market** is a market for goods—such as computers—or services—such as medical treatment. A **factor market** is a market for the factors of production, such as labor, capital, natural resources, and entrepreneurial ability. **Factors of production** are labor, capital, natural resources, and other inputs used to make goods and services.

A. The Circular Flow of Income

A **circular-flow diagram** is a model that illustrates how participants in markets are linked. The diagram demonstrates the interaction between firms and households in both product and factor markets.

B. The Gains from Free Markets

A **free market** is a market with few government restrictions on how a good or service can be produced or sold or on how a factor of production can be employed. Adam Smith is considered the father of modern economics. His book, *An Inquiry into the Nature and Causes of the Wealth of Nations*, published in 1776, was an influential argument for the free market system.

C. The Market Mechanism

A key to understanding Adam Smith's argument is the assumption that individuals usually act in a rational, self-interested way. This assumption underlies nearly all economic analysis.

D. The Role of the Entrepreneur in the Market System

Entrepreneurs are an essential part of a market economy. An **entrepreneur** is someone who operates a business, bringing together the factors of production—labor, capital, and natural resources—to produce goods or services. Entrepreneurs often risk their own funds to start businesses and organize factors of production to produce those goods and services that consumers want.

E. The Legal Basis of a Successful Market System

The absence of government intervention is not enough for a market economy to work well. Government has to provide a legal environment that allows markets to operate efficiently. **Property rights** are the rights individuals or businesses have to the exclusive use of their property, including the right to buy or sell it. To protect intellectual property rights, the federal government grants inventors patents. A patent grants the exclusive right to produce and sell a new product for 20 years from the date the patent is filed. Books, films, and software receive copyright protection. Under U.S. law, the creator of a book, film, or piece of music has the exclusive right to use the creation during the creator's lifetime. The creator's heirs retain this right for 70 years after the death of the creator.

Teaching Tips

To initiate class discussion regarding intellectual property rights, ask students these questions:

1. How many of you have downloaded music from the Internet?
2. Should the government have the right to grant exclusive rights to musicians and other artists to produce and sell their creative works?
3. Should the government fine or prosecute people who illegally obtain music, books, movies, and other creative works in violation of property rights laws?

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Extra **Solved Problem 2.3**

Adam Smith's "Invisible Hand"

The late economist Alan Krueger argued that Adam Smith was concerned that the invisible hand would not function properly if merchants and manufacturers convinced the government to issue regulations to help them.

Source: Alan B. Krueger, "Rediscovering the Wealth of Nations," *New York Times*, August 16, 2001.

a. What types of regulations might merchants and manufacturers seek from the government?

b. How might these regulations prevent the invisible hand from working?

Solving the Problem

Step 1: **Review the chapter material.** This problem is about how goods and services are produced and sold and how factors of production are employed in a free market economic system as described by Adam Smith in *An Inquiry into the Nature and Causes of the Wealth of Nations*, so you may want to review the section "The Gains from Free Markets."

Step 2: **Answer part (a) by describing the economic system in place in Europe in 1776.** At the time, governments gave guilds—associations of producers—the authority to control production. The production controls limited the output of goods such as shoes and clothing, as well as the number of producers of these items. Limiting production and competition led to higher prices and fewer choices for consumers. Instead of catering to the wants of consumers, producers sought favors from government officials.

Step 3: **Answer part (b) by contrasting the behavior of merchants and manufacturers under a guild system and in a market system.** Because governments in a guild system gave producers the power to control production, producers did not have to respond to consumers' demands for better quality, greater variety, and lower prices. In a market system, producers who sell poor quality goods at high prices suffer economic losses; producers who provide better quality goods at low prices are rewarded with profits. Therefore, it is in the self-interest of producers to address consumer wants. This is how the invisible hand works in a free market economy but not in most of Europe in the eighteenth century.

Extra Analyze the Concept

An Elementary Case of Copyright

The U.S. Congress provides copyright protection to authors to give them an economic incentive to invest the time and effort required to write books. While a book is under copyright, only the author—or whoever the author sells the copyright to—can legally publish a paper or digital copy of the book. Once the copyright expires, however, the book enters the *public domain*, and anyone is free to publish the book. Copies of classic books written in the 1800s, such as Mark Twain's *Huckleberry Finn* and Charles Dickens's *Oliver Twist*, are available from many publishers that do not have to pay a fee to the authors' heirs.

Arthur Conan Doyle was a doctor in England when he published his first story featuring the detective Sherlock Holmes in 1887. Anyone who wants to publish any of the Sherlock Holmes stories that Doyle wrote from 1887 through the end of 1922 is free do so. But the last 10 Sherlock Holmes stories that Doyle

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wrote from 1923 to 1927 remain under copyright protection. Doyle's heirs argue that because the author continued to develop the personalities of Sherlock Holmes and his companion Dr. John Watson in the 10 stories that remain under copyright protection, the characters cannot be used in new books, films, or television shows without payment. Doyle's heirs have asked anyone who wants to include Holmes in a new work to pay them a fee of $5,000 per use.

The producers of two recent Sherlock Holmes films starring Robert Downey, Jr., and the producers of the television series *Sherlock*, starring Benedict Cumberbatch, and *Elementary*, starring Jonny Lee Miller, agreed to pay the fee, as have most authors of books using Holmes as a character. In 2011, when Leslie S. Klinger published *A Study in Sherlock*, a collection of new stories involving Sherlock Holmes, his publisher insisted that he pay the usual fee to Doyle's descendants. But two years later, when Klinger decided to publish another collection, *In the Company of Sherlock Holmes*, he decided that rather than pay the fee he would sue Doyle's descendants, hoping the federal courts would rule against their copyright claims.

Federal Appeals Judge Richard Posner—who is also an economist—eventually ruled in favor of Klinger. He argued that copyright law did not allow authors or their heirs to require fees for the use of characters from stories in the public domain. He also noted that, "the longer the copyright term is, the less public-domain material there will be and so the greater will be the cost of authorship, because authors will have to obtain licenses from copyright holders for more material." As a result of this ruling, for the first time since 1887, anyone can use Sherlock Holmes as a character in a book, television show, or movie without having to pay a fee.

Sources: Jennifer Schuessler, "Appeals Court Affirms Sherlock Holmes Is in Public Domain," *New York Times*, June 17, 2014; Jennifer Schuessler, "Conan Doyle Estate Told to Pay Legal Fees," *New York Times*, August 5, 2014; Eriq Gardner, "Conan Doyle Estate Loses Appeal Over 'Sherlock Holmes' Rights," *Hollywood Reporter*, June 16, 2014; and *Leslie S. Kling v. Conan Doyle Estate, Ltd*. (7th Cir. 2014), media.ca7.uscourts.gov.

Extra Analyze the Concept | Managers at Feeding America Use the Market Mechanism to Reduce Hunger

Charitable giving doesn't seem to have much to do with markets. When donors give money, clothing, or food to a charity, they typically don't expect anything in exchange—beyond a possible tax deduction. In 1979, retired businessman John van Hengel started Feeding America. This charity collects donations of food from farmers, supermarkets, food processing plants, and governments and distributes the food to thousands of food pantries and food programs operated by churches, schools, and community centers around the country. These programs give the donated food away free or at a very low price to low-income families.

By 2004, Feeding America was providing 1.8 billion pounds of food per year to millions of low-income people, but the organization's managers realized that they could serve even more people if they could operate more efficiently. In particular, the managers were concerned that food was sometimes not allocated in ways that were consistent with the needs of local food programs. For example, potatoes might be shipped to food programs in Idaho—the country's leading potato growing state—or milk might be shipped to food programs that lacked the refrigeration capacity to keep it fresh long enough to distribute. In 2005, Feeding America asked Canice Prendergast, Don Eisenstein, and Harry Davis, professors at the University of Chicago's Booth School of Business, to design a more efficient way of allocating food to local food programs.

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Feeding America had been allocating food by calculating how many low-income people lived in an area and then shipping a target number of pounds of food to food programs in the area. All food, whether fruit, bread, milk, or pasta, that weighed the same was treated the same in making allocations to local food programs. The food programs were not allowed to choose which foods they wanted to receive. Because Feeding America provided on average only about 20 percent of the total food donations local food programs received, it might ship food—for example, bread and breakfast cereal—the local program already had, while failing to ship food, such as fruits and vegetables, that the program needed.

The business professors advising Feeding American proposed changing the food allocation system to one that resembled a market. Each food program was given a number of "shares" that they could use in bidding against other food programs for the types of food that best met the needs of the low-income people using their program. In addition, any local program that had surplus food was allowed to sell it to other local programs in exchange for shares. Although this new system does not involve money, it operates like a market—in which consumers determine prices by competing against each other in buying goods. Goods for which consumers have a greater preference tend to have higher prices than goods for which consumers have a lesser preference; for instance, in supermarkets, organic produce often sells for a higher price than nonorganic produce. Similarly, food programs turned out to have a stronger preference for fresh fruits and vegetables than for pasta. Under the previous system, a pound of fresh fruit would have been treated the same as a pound of pasta in calculating how much food Feeding America would allocate to a local program. But when under the new system local food banks were allowed to bid for food with shares, the price of a pound of fruit or vegetables was 116 times higher than the price of a pound of pasta.

Because under the new system food is allocated in a way that more closely fits the needs of local food programs, Feeding America is able to provide food to thousands more low-income people than was possible under the old system. In addition, because less food is wasted, people and organizations have been willing to donate more food to the program. Finally, Feeding America's managers have used the knowledge of which types of foods local food programs prefer to guide the types of food they ask companies to donate. For instance, in addition to fruits and vegetables, programs are willing to pay more shares for peanut butter and frozen chicken because these foods are easy to store. Even many critics of using a market mechanism to allocate food donations eventually embraced the system, including the director of one Michigan food program whose initial reaction was: "I am a socialist. That's why I run a food bank. I don't believe in markets." The success of Feeding America's revised procedures for allocating food donations shows how powerfully market mechanisms can increase efficiency and raise living standards.

Sources: Sendhil Mullainathan, "Sending Potatoes to Idaho? How the Free Market Can Fight Poverty," *New York Times*, October 7, 2016; Canice Prendergast, "The Allocation of Food to Food Banks," Working Paper, University of Chicago, Booth School of Business, October 11, 2016; Ray Fisman and Tim Sullivan, "The Invisible Helping Hand," slate.com, June 7, 2016; and feedingamerica.org.

Extra Economics in Your Life & Career:

Economists Express Their Agreement on Free Trade

During the summer of 2017, fifteen former leaders of the White House Council of Economic Advisors signed a letter to President Trump urging him not to place tariffs on imports of steel into the United States. The letter notes that "Among us are Republicans and Democrats alike, and we have disagreements on a number of policy issues. But on some policies there is near universal agreement. One such issue is the harm of imposing tariffs on steel imports." Tariffs are taxes imposed by government on imports. Those who endorse tariffs and other barriers to free international trade believe that such barriers protect domestic industries and the jobs of their employees.

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Questions: (a) Why do many economists, including those who have served for both Republican and Democratic administrations, support free trade policies and oppose tariffs and trade barriers even if these barriers are designed to protect domestic workers from losing their jobs? (b) What types of jobs would be most vulnerable to job losses due to competition from imports?

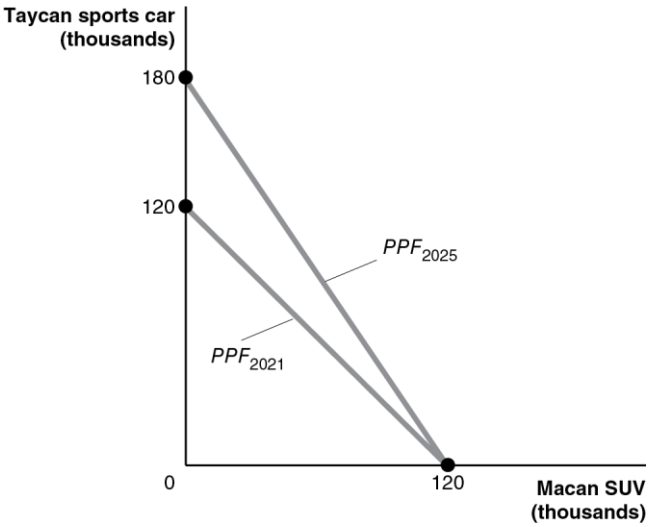
Answers: (a) As you learned in this chapter, countries are better off if they specialize in producing goods and services in which they have a comparative advantage and trading with other countries for other goods and services. Tariffs prevent countries from taking full advantage of the benefits from free trade. The argument that economists who have worked for both Democratic and Republican governments made is based on positive economic analysis (analysis concerned with what is) rather than normative analysis (analysis concerned with what ought to be). Ben Bernanke, former chairman of the Federal Reserve Board, has cited a study that examined the effect of international trade on income in the United States since World War II: "… the increase in trade… has boosted U.S. annual incomes on the order of $10,000 per household. The same study found that removing all remaining barriers to trade would raise incomes anywhere from $4,000 to $12,000 per household."

(b) Another study cited by Bernanke found that the 21 occupations in the United States that were most vulnerable to imports from foreign firms were primarily for relatively low-wage positions. In general, the greater the skill requirements for the job you hold, the less vulnerable you will be to losing your job due to competition from imports.

Sources: Nick Timiraos, "Former White House Economists to Donald Trump: Don't Impose Steel Tariffs," *Wall Street Journal*, July 12, 2017; Ben Bernanke, "Embracing the Challenge of Free Trade: Competing and Prospering in a Global Economy," The Federal Reserve Board, May 1, 2007. https://www.federalreserve.gov/boarddocs/speeches/2007/20070501/default.htm; and "Why Open Markets Matter," http://www.oecd.org/trade/understanding-the-global-trading-system/why-open-markets-matter/

Solutions to End-of-Chapter Exercises

Answers to *Thinking Critically* Questions to accompany the *Inside Look* newspaper feature



1. In 2021, maximum production is 120,000 Taycan sports cars or 120,000 Macan SUVs, so to gain 1 Taycan sports car, Porsche must give up 1 Macan SUV. In 2025, maximum production is 180,000 Taycan sports cars or 120,000 Macan SUVs, so to gain 1 Taycan sports car, Porsche must give up two-thirds of a Macan SUV. Therefore:
   - The opportunity cost of 1 Taycan sports car in 2021 is 1 Macan SUV.
   - The opportunity cost of 1 Taycan sports car in 2025 is two-thirds of a Macan SUV.
2. The production alternative of 75,000 Taycan sports cars and 125,000 Macan SUVs lies inside the 2025 production possibilities frontier (*PPF*) in the textbook and is, therefore, a possible production alternative. The *PPF* drawn to answer the previous problem assumes that the maximum number of Macon SUVs in 2025 is only 120,000. For this *PPF*, it would not be possible to produce 125,000 Macon SUVs.

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2.1 Production Possibilities Frontiers and Opportunity Costs

Learning Objective: Use a production possibilities frontier to analyze opportunity costs and trade-offs.

Review Questions

1.1 Scarcity is the situation in which wants exceed the limited resources available to fulfill those wants. There are some things that are available in such abundance that they exceed our wants. For example, for most people there is enough oxygen in the atmosphere that the amount they want to inhale would not exceed the available amount—so oxygen isn't scarce for them. Another example might be something undesirable, such as weeds in your garden.

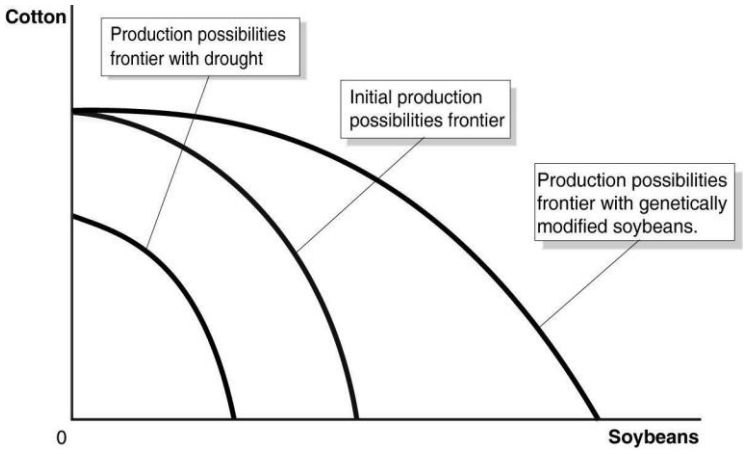
1.2 The production possibilities frontier (*PPF*) is a curve showing all the attainable combinations of two products that can be produced with available resources and existing technology. Combinations of goods that are on the frontier are efficient because all available resources are being fully used, and the fewest possible resources are being used to produce a given amount of output. Points inside the *PPF* are inefficient because the maximum output is not being obtained from the available resources. A *PPF* will shift outward (to the right) if more resources become available for making the products or if technology improves so that firms can produce more output with the same amount of inputs.

1.3 Increasing marginal opportunity costs means that as more and more of a product is made, the opportunity cost of making each additional unit rises. This occurs because the first units of a good are produced with the resources that are best suited for making it, but as more and more of the good is produced, resources must be used that are better suited for producing something else. Increasing marginal opportunity costs imply that the production possibilities frontier (*PPF*) is bowed out—the slope of the *PPF* gets steeper and steeper as you move down the frontier.

Problems and Applications

1.4 **a.** The production possibilities frontiers in the figure are bowed outward because of increasing marginal opportunity costs. The drought causes the production possibilities frontier to shift to the left (see the graph in part (b)).

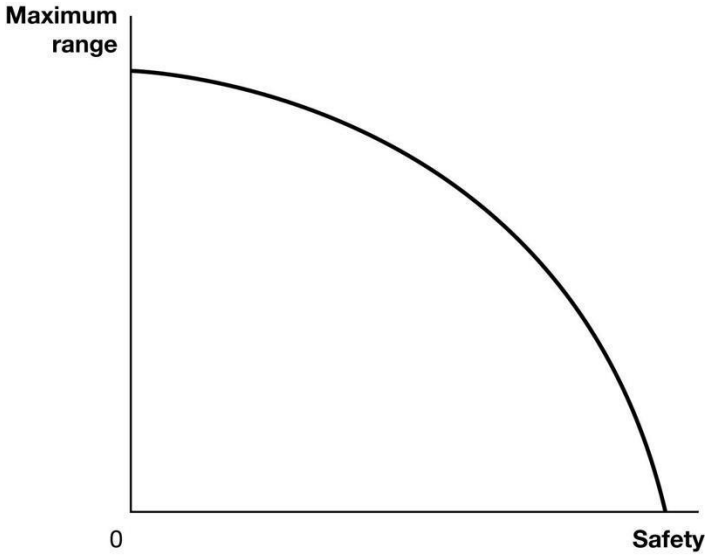
b. The genetic modifications would increase the maximum soybean production, which we can show by shifting out where the *PPF* intersects the horizontal axis, but the maximum amount cotton production would be unchanged



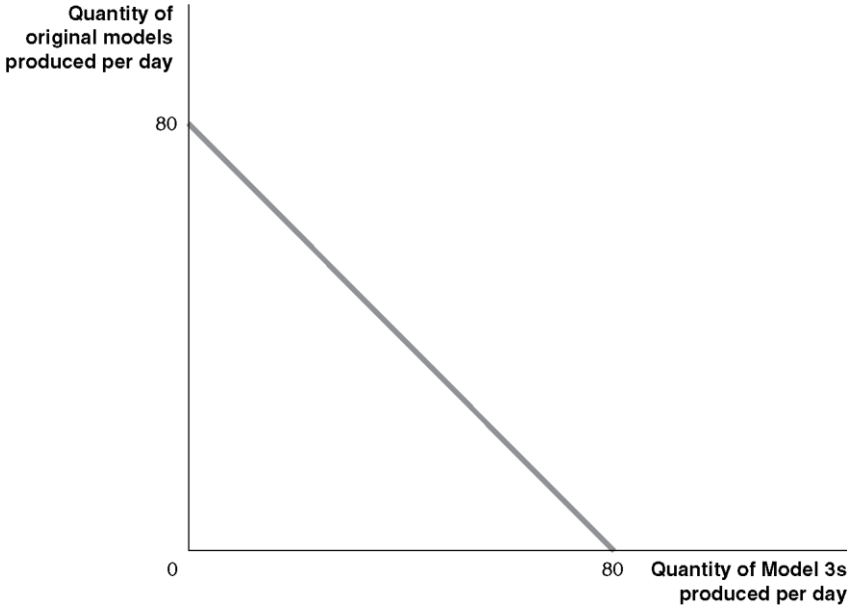
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1.5 Increased safety will decrease the maximum range for an electric car, as shown in the following figure. Trade-offs can be between physical goods, such as cotton and soybeans in problem 1.4, or between the features of a product, like the maximum range and safety of an electric car.



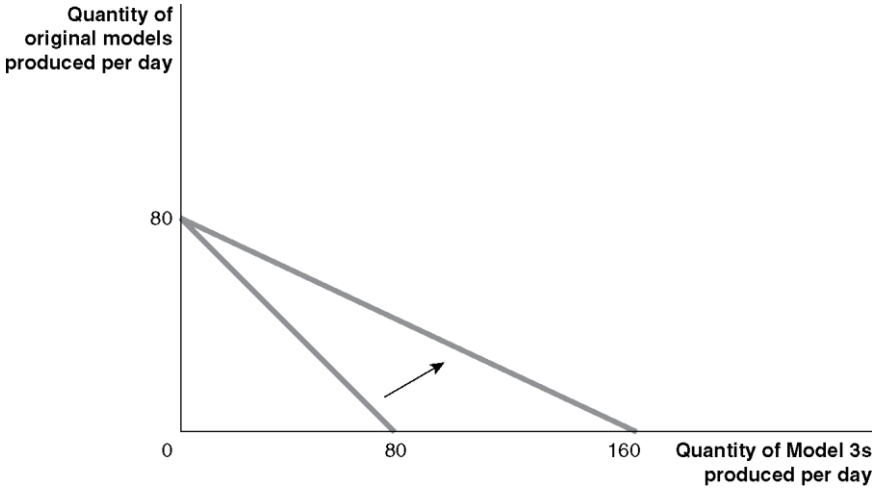
1.6 **a.** You should draw a figure like Figure 2.1 in the chapter that shows the trade-off Tesla faces between producing Model 3s and the Model S and Model X. We can assume that the capacity in the Fremont factory is the same as that assumed in Figure 2.1



b. Because Tesla's factory in China will produce only Model 3 cars, its opening does not affect the quantity of original models the company produces. We can show this change on a production possibilities frontier (*PPF)* by keeping the maximum quantity of original models Tesla can produce per day fixed at 80, while pivoting the *PPF* to increase the maximum number of Model 3 cars Tesla can produce per day. We don't know how many additional Model 3s Tesla can produce in its new China factory. If the China factory has the same capacity as the

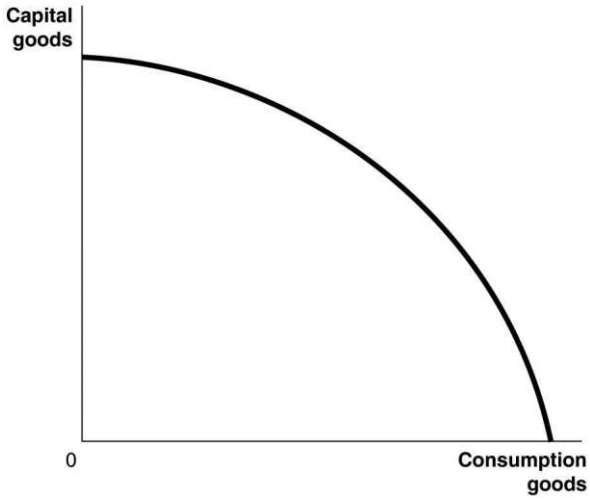
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Fremont factory, then the maximum quantity of Model 3s Tesla can produce per day will increase from 80 to 160.



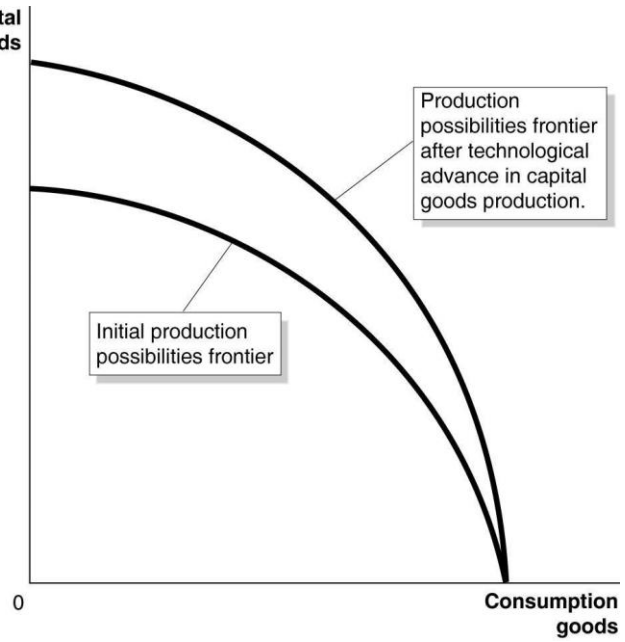
1.7 You could argue that the price paid for a book is a close approximation to the opportunity cost of *buying* a book, but *consuming*—that is, reading—the book could require many hours of leisure time that could be spent on some other activity. The time spent reading a book always has an opportunity cost.

1.8 **a.** The production possibilities frontier will be bowed out like Figure 2.2 because some economic inputs are likely to be more productive when making capital goods, and others are likely to be more productive when making consumption goods.

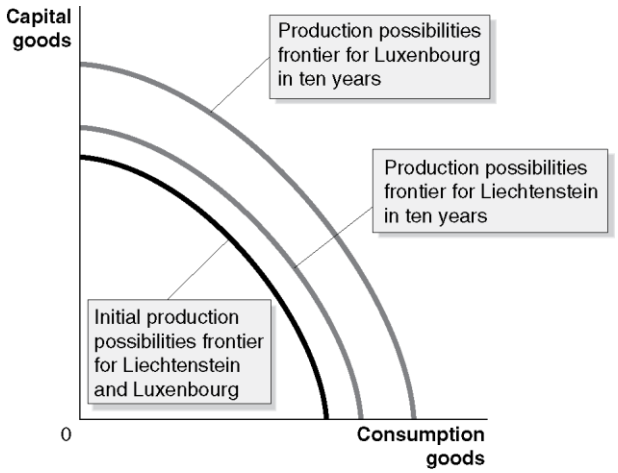


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b.



c. Because Luxembourg will have more capital goods, such as machinery, equipment, and robots, it is likely to experience more rapid growth in the future than Liechtenstein.



1.9 **a**. Point *E* is outside the production possibilities frontier, so it is unattainable.

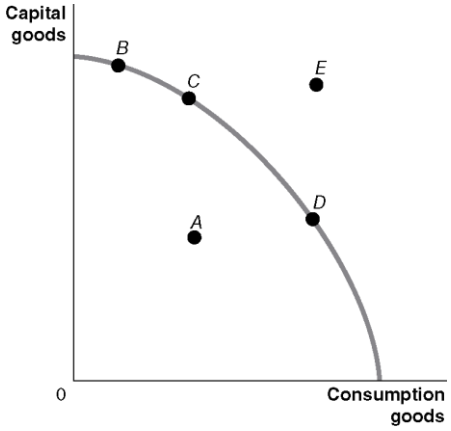
b. Points *B*, *C*, and *D* are on the production possibilities frontier, so they are efficient.

c. Point *A* is inside the production possibilities frontier, so it is inefficient.

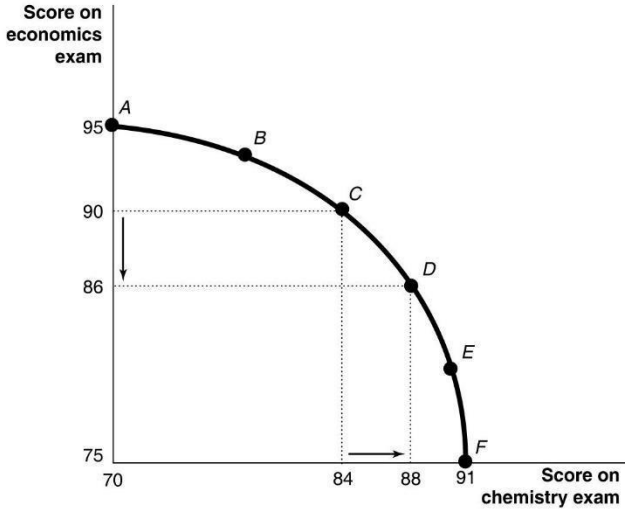
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d. At point *B*, the country is devoting the most resources to producing capital goods, so production at this point is most likely to lead to the highest growth rate. The more capital goods the country produces, the greater the capacity of the country to produce goods and services in the future.



1.10 a.



If you spend all 5 hours studying for your economics exam, you will score a 95 on the exam; therefore, your production possibilities frontier will intersect the vertical axis at 95. If you devote all 5 hours studying for your chemistry exam, you will score a 91 on the exam; therefore, your production possibilities frontier will intersect the horizontal axis at 91.

b. The points for choices *C* and *D* can be plotted using information from the table given in the problem. Moving from choice *C* to choice *D* increases your chemistry score by 4 points but lowers your economics score by 4 points. Therefore, the opportunity cost of increasing your chemistry score by 4 points is the decline of 4 points in your economics score.

c. Choice *A* might be sensible if the marginal benefits of doing well on the chemistry exam are low relative to the marginal benefits from doing well on the economics exam. For example, that choice might be sensible if: (1) you are majoring in economics and don't care much about chemistry; or (2) if you already have an A sewn up in chemistry, but the economics professor will replace a low exam grade with this exam grade.

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1.11 **a.** By reducing firms' potential profits from selling new drugs and medical devices, price regulation may reduce the incentive firms have to devote resources to the research and development necessary to develop these products.

b. From the point-of-view of the public, the opportunity cost of regulating the prices of pharmaceuticals and medical devices is the decline in the number of these products that firms will develop following the imposition of the price regulations. The public would be trading off lower prices today for less effective health care in the future. The presidential candidate may also want to consider whether implementing price regulations on pharmaceuticals and medical devices might lead Congress to impose price regulations on other goods and services. Doing so could interfere with the operation of the market system as described later in this chapter in Section 2.3.

1.12 State governments have limited budgets. Subsidies paid by state governments for prescription drugs under the Medicaid program use tax revenue that could otherwise be used to pay for other valuable goods and services, including highway and bridge repair and funding of schools. Nearly all state governments are required by their constitutions to balance their budgets. Therefore, increases in spending on one program require either a reduction in spending on other programs or an increase in taxes. Facing this trade-off, some states have subsidized expensive drugs only for patients with the most serious illnesses. How best to allocate a state government's limited resources is a normative issue and depends on how governors and state legislators evaluate the trade-offs involved.

1.13 Resources used to reduce pollution are not available for other uses, such as saving lives through medical research, so it is more ethical to take into account the opportunity cost of reducing pollution.

1.14 Economic systems that do not allow people to keep most of the output they produce do not provide much incentive for people to work hard. Unfortunately, experience has shown that people are more self-interested and less altruistic than would be necessary for the system used in Oz to work in the real world.

2.2 Comparative Advantage and Trade

Learning Objective: Describe comparative advantage and explain how it serves as the basis for trade.

Review Questions

2.1 Absolute advantage is the ability of an individual, a firm, or a country to produce more of a good or service than competitors using the same amount of resources. Comparative advantage is the ability of an individual, a firm, or a country to produce a good or service at a lower opportunity cost than competitors. It is possible for a country to have a comparative advantage in producing a good even if another country has an absolute advantage in producing that good (and every other good). Unless the two countries have exactly the same opportunity costs of producing two goods—the same trade-off between the two goods—one country will have a comparative advantage in making one of the goods and the other country will have a comparative advantage in making the other good.

2.2 The basis for trade is comparative advantage. If each party specializes in making the product for which it has a comparative advantage, trading makes each of them better off. Each party will be

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able to obtain the product made by its trading partner at a lower opportunity cost than it would be able to produce it without trade.

Problems and Applications

2.3 In the example illustrated in Figure 2.4, the opportunity cost of 1 pound of apples is 1 pound of cherries to you and 2 pounds of cherries to your neighbor. Any price of apples between 1 and 2 pounds of cherries will be a fair trading price and, because exchanging 10 pounds of apples for 15 pounds of cherries represents the same price as when exchanging 1 pound of apples for 1.5 pounds of cherries, the price falls within this range. We could take any other value in this range to complete the table. Let's take, for example, 1.25 pounds of cherries per pound of apples. We will keep the pounds of apples traded as before at 10. The completed table will now be:

TABLE 2.1: A Summary of the Gains from Trade

	You		Your Neighbor	
	Apples (pounds)	**Cherries (pounds)**	**Apples (pounds)**	**Cherries (pounds)**
Production *and* consumption *without* trade	8	12	9	42
Production *with* trade	20	0	0	60
Consumption *with* trade	10	10 × 1.25 = 12.5	10	60 − 12.5 = 47.5
Gains from trade (increased consumption)	2	12.5 − 12 = 0.5	1	47.5 − 42 = 5.5

Note that both you and your neighbor are better off after trade than before trade. Note also that this rate of trading cherries for apples is better for your neighbor than the original rate of trading and worse for you.

2.4 As explained in this section of the chapter, when individuals, firms, or countries specialize in producing goods or services in which they have a comparative advantage, they are producing at the lowest cost. When McKenzie refers to goods that can be "made more cheaply abroad," he means the goods are being produced in countries that have a comparative advantage in producing them. The goods that can be "made more cheaply at home" are the goods in which the home country has a comparative advantage. As this section of the chapter shows, when countries specialize in producing goods in which they have a comparative advantage and trade for goods in which other countries have a comparative advantage, the incomes of all countries can increase.

2.5 **a.** Canada has a comparative advantage in making boots. Canada's opportunity cost of making 1 boot is giving up 1 shirt. In the United States, the opportunity cost of making 1 boot is giving up 3 shirts. The United States has a comparative advantage in making shirts. In the United States, the opportunity cost of making one shirt is giving up 1/3 boot, but Canada's opportunity cost of making 1 shirt is 1 boot.

b. Neither country has an absolute advantage in making both goods. The United States has an absolute advantage in making shirts, but Canada has an absolute advantage in making boots. Remember that both countries have the same amount of resources. If each country puts all of its resources into making shirts, then the United States makes 12 shirts, but Canada makes only 6 shirts. If each country puts all of its resources into making boots, then Canada makes 6 boots, but the United States makes only 4 boots.

c. If each country specializes in the production of the good in which it has a comparative advantage and then trades with the other country, both will be better off. Let's use the case in which each country trades half of what it makes for half of what the other makes. The United States will specialize by making 12 shirts, and Canada will specialize by making 6 boots. Because each country gets half of the other country's production, they both end up with 6 shirts

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and 3 boots. They are better off than before trading because they end up with the same number of boots, but twice as many shirts. Other trades will also make them better off.

2.6 **a**. By writing "China is always better than Spain" at producing textiles, the columnist means that China has an absolute advantage in producing textiles.

b. Assuming that Spain has a comparative advantage in producing textiles (that is, it can produce textiles at a lower opportunity cost than China can), Spain can sell textiles to Chinese firms and consumers at a lower price than Chinese textile producers can charge even if China has an absolute advantage in producing textiles.

2.7 **a.** When the United Kingdom produces 1 more barrel of fish oil, it produces 1 less barrel of crude oil. When Norway produces 1 more barrel of fish oil, it produces 1 less barrel of crude oil. Therefore, neither country has a comparative advantage in either good. In both countries, the opportunity cost of 1 barrel of crude oil is 1 barrel of fish oil. Comparative advantage arises only if an individual, a firm, or a country has a lower opportunity cost of producing a good, but these two countries have the same opportunity cost. (Note, though, that the United Kingdom has an absolute advantage in producing both goods because it can produce more of each than can Norway using the same amounts of capital and labor.)

b. No, the countries can't gain from trade. Trading across the border would result in the same trade-offs that can be made within each country.

2.8 **a.** When France produces 1 more bottle of wine, it produces 2 fewer pounds of cheese. When Germany produces 1 more bottle of wine, it produces 3 fewer pounds of cheese. Therefore, France's opportunity cost of producing wine—2 pounds of cheese—is less than Germany's—3 pounds of cheese. When Germany produces 1 more pound of cheese, it produces 0.33 fewer bottles of wine. When France produces 1 more pound of cheese, it produces 0.50 fewer bottles of wine. Therefore, Germany's opportunity cost of producing cheese —0.33 bottles of wine— is less than that of France—0.50 bottles of wine. We can conclude that France has a comparative advantage in making wine and that Germany has a comparative advantage in making cheese.

b. We know that France should specialize where it has a comparative advantage and Germany should specialize where it has a comparative advantage. If both countries specialize, France will make 4 bottles of wine and 0 pounds of cheese, and Germany will make 0 bottles of wine and 15 pounds of cheese. After both countries specialize, France could then trade 3 bottles of wine to Germany in exchange for 7 pounds of cheese. France will have the same amount of wine as it initially had, but 1 more pound of cheese. Germany will have 3 bottles of wine and 8 pounds of cheese —that is, the same amount of wine, but 2 more pounds of cheese. Other mutually beneficial trades are possible.

2.9 No individual or a country can produce beyond its production possibilities frontier (*PPF*). The *PPF* shows the most that an individual or a country can produce for a given amount of resources and technology. Without trade, an individual or a country cannot consume beyond its *PPF*, but with specialization and trade each can consume beyond its *PPF*. We saw two examples in the chapter: In Figure 2.5, both you and your neighbor were able to consume beyond your *PPF*s. In Solved Problem 2.2, both Canada and the United States were able to consume beyond their *PPF*s.

2.10 Colombia could have a comparative advantage in producing coffee if Nicaragua has an even larger absolute advantage relative to Colombia at producing another product. If, for example, Nicaragua can produce four times more cashews than Colombia can using the same resources, then Colombia will have a comparative advantage in producing coffee.

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2.11 Aaron Rogers and you are using absolute advantage, not comparative advantage, to decide what to do. Rogers has a comparative advantage at playing quarterback because even though he is five times better at selling Packers memorabilia than any other employee or player, he has an even larger absolute advantage in playing quarterback. You, as a creative and effective leader, have a comparative advantage in leading the organization. Your absolute advantage in leading is even larger than your absolute advantage in cleaning offices.

2.12 Falling transportation costs allowed people to trade more easily and to specialize on the basis of comparative advantage. If people were able to specialize, they would be more productive and, in turn, earn more income.

2.13 Importing only products that could not be produced here would result in the United States producing—rather than importing—many goods for which it does not have a comparative advantage. These products would be produced at a higher opportunity cost than if they had been imported. The policy would result in a lower standard of living in the United States.

2.14 Even though you are better at unloading the dishwasher, you might be even better relative to the other members of the household at other household chores. You have an absolute advantage in unloading the dishwasher, but you might have an even larger absolute advantage at other household chores. Having an absolute advantage does not mean that you have a comparative advantage in unloading the dishwasher. Household production will be accomplished in fewer hours if each member of the household performs chores in which he or she has a comparative advantage.

2.15 The amount of time that family members spend on household chores has changed over the years for a number of reasons, including changes in the average number of children per household and the average age that couples marry. But the most important reason the number of hours of housework has fallen since 1965 is probably due to technological change. It takes the average household less time to do laundry, wash dishes, and perform other household chores. This reduction has allowed men and women more time to spend working outside the home or engaging in leisure activities without having to put up with messier homes.

2.3 The Market System

Learning Objective: Explain the basics of how a market system works.

Review Questions

3.1 The circular-flow diagram illustrates how participants in markets are linked. It shows that in factor markets, households supply labor and other factors of production in exchange for wages and other payments from firms. In product markets, households use the payments they earn in factor markets to purchase the goods and services produced by firms.

3.2 The two main categories of market participants are households and firms. Households are consumers and are of greatest importance in determining what goods and services are produced. Firms make a profit only when they produce goods and services valued by consumers. Therefore, only the goods and services that consumers are willing and able to purchase are produced.

3.3 A free market is a market with few government restrictions on how goods or services can be produced or sold, or on how factors of production can be employed. In a free market economy, buyers and sellers in the marketplace make economic decisions. In a centrally planned economy, the government—rather than households and firms—makes almost all the economic decisions. Free

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market economies have a much better track record of providing people with rising standards of living.

3.4 An entrepreneur operates a business. Entrepreneurs play a key role in the economy by bringing together the factors of production—labor, capital, and natural resources—to produce goods and services for sale. Entrepreneurs decide what to produce and how to produce it. They put their own funds or borrowed funds at risk to start a business.

3.5 Firms are likely to produce more of a good or service if consumers want more of it. As consumer demand rises, price will rise, which will lead firms to produce more. If demand falls, price will fall, which will lead firms to produce less.

3.6 Private property rights are the rights individuals or firms have to the exclusive use of their property, including the right to buy or sell it. If individuals and firms believe that property rights are not well enforced, they will be reluctant to risk their wealth by opening new businesses. Therefore, the enforcement of property rights and contracts is vital for the functioning of the economy. Independent courts are crucial because property rights and contracts will be enforced only if judges make impartial decisions based on the law, rather than decisions that favor powerful or politically connected individuals.

Problems and Applications

3.7 **a.** An auto purchase takes place in the product market. The household (Tariq) demands the good, and the firm (Tesla Motors) supplies the good.

b. The labor market is a factor market. Households supply labor, and the firm demands labor.

c. The labor market is a factor market. The household (Tariq) supplies a factor of production (labor), while the firm (McDonald's) demands it.

d. The land market is a factor market. The household (Tariq) supplies a factor of production (land), and the firm (McDonald's) demands it.

3.8 Firms typically are trying to make the most profit possible, while consumers are trying to spend their incomes in a way that gives them the greatest satisfaction. Neither firms nor consumers are directly interested in increasing economic efficiency or the standard of living of the average person. But the interaction of firms and consumers in markets produces outcomes that are economically efficient and that promote the economic growth that results in rising living standards. This idea is an important intellectual contribution for two reasons: 1) It is not obvious that an outcome can result even though the people involved don't intend for that outcome to occur and 2) this idea forms the basis for understanding the favorable economic outcomes that result from a market system.

3.9 It was not necessary for the managers of any of the firms that participated in the making of the pencils described in Leonard Read's story to know how the components they produced were used to make pencils. Nor was it necessary for the chief executive officer of the Eberhard Faber Company to have this knowledge. All of the companies were motivated by their own self-interest in providing the materials and services used to make pencils. This account is an illustration of Adam Smith's "invisible hand" metaphor.

3.10 Adam Smith realized—as economists today realize—that people's motives can be complex. But in analyzing people in the act of buying and selling, economists have concluded that in most instances, the motivation of financial reward provides the best explanation for the actions people take.

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Moreover, being self-interested—looking out for your own well-being and happiness—and being selfish—caring only about yourself—are not the same thing. Many successful businesspeople are, in fact, generous: Donating to charity, volunteering for charitable activities, and otherwise acting in a generous way. These actions are not inconsistent with making business decisions that maximize profits for their companies.

3.11 Whether self-interest is an "ignoble human trait" is a matter of opinion. There are certainly more noble traits than self-interest, but without at least some self-interest, a person wouldn't survive. A market system encourages self-interest in the sense that it paradoxically allows people to enrich themselves by fulfilling the needs of others; that is, by producing goods and services that fulfill the wants of consumers.

3.12 **a**. "Psychic rewards" refer to the psychological benefits of, in this case, buying lottery tickets, which provide the excitement of playing the lottery and the chance of winning big.

b. An entrepreneur might receive the psychic rewards of creating and running his or her own business along with the chance of making large profits.

c. Answers will vary here. Elements of being an entrepreneur do appear to be similar to buying a lottery ticket with the psychic rewards of playing the game along with the possibility of large returns. Other elements may differ, such as the probability of success. Although a purchaser of a lottery ticket may know at least roughly the probability that she will win the lottery, the probability that an entrepreneur will earn a high return is much more difficult for her to calculate.

3.13 **a.** Property rights–including intellectual rights to new products and the processes used to produce goods and services—refer to the rights of firms and individuals to have exclusive use of their property. It is the responsibility of government to ensure that such rights are protected. Property rights provide incentives for people to maintain and increase the value of the property they own.

b. By protecting private property rights, governments make it more likely that investments will be made in businesses that provide jobs and income for workers. This activity results in an increase in a country's standard of living. It is difficult for a country to become rich without having secure property rights.

c. Without secure property rights, farmers in Africa may be reluctant to make the investments in their farms that would raise the farms' productivity. When farmers have secure property rights, they can borrow more easily by using their land as collateral, which means that if the farmer stops making payments on the loan, the bank or other lender can seize the land and sell it to get its money back. Without collateral, people with low incomes often have trouble getting loans. Using their land as collateral, farmers can borrow the funds they need to make investments that will raise their farms' productivity. With secure property rights, farmers can also obtain funds by selling some of their land.

3.14 In a market system, an increase in demand for a good leads to an increase in the price of the good. The higher price provides a signal to producers that the good has become more profitable. Given that lithium prices are rising, mining firms are likely to switch some of their labor and capital from producing iron, copper, and cobalt to producing lithium.

3.15 The columnist is likely defining socialism to refer to a centrally planned economy in which the government directly controls most production. U.S. socialists like Senator Bernie Sanders and Congresswoman Alexandria Ocasio-Cortez would be unlikely to accept the columnist's definition

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of socialism. Their view of socialism is similar to that of the social democratic parties in Western Europe. These parties back an expanded role for government, particularly in the provision of services such as health care, but do not usually propose widespread government ownership of businesses.

Suggestions for the *Thinking Critically Exercise*

CT2.1 It will be difficult for a group to come up with a product made entirely by only one company as few companies are completely vertically integrated (oil companies are one example). So, this question is exploring specialization. The text explores this idea in the *Apply the Concept*, "A Story of the Market System in Action: How Do You Make an iPad?" in Section 2.3.

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