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Chapter 2

The Market System and the Circular Flow

TEACHING GUIDE CONTENTS

CHAPTER 2 CONNECT ASSET MAP

WHAT'S NEW IN CHAPTER 2

SUGGESTIONS FOR IMPLEMENTATION

LEARNING OBJECTIVES

OVERVIEW OF THE CHAPTER

COMMENTS AND TEACHING SUGGESTIONS

STUDENT STUMBLING BLOCKS

LECTURE OUTLINE

QUIZ

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CONNECT ASSET MAP FOR CHAPTER 2

Chapter 2: The Market System and the Circular Flow	
SmartBook 2.0	The Market System and the Circular Flow
End of Chapter Exercises	
Economics and Ethics Discussion Questions*	Economics as a Social Science
	Rawlsian Welfare
Application-Based Activity*	Economic Models: Inputs and Outputs
Test Bank	

*All content marked with an asterisk is available for assignment in the "course-wide content" menu in the Connect question picker. New Experience > Assignments > Add Assignment > Question Bank > Course-Wide Content Dropdown Tab >

**The full Connect Asset Map for the entire product can be found in the Instructor's Resource Page. Click path in Connect: New Experience > Dashboard > Instructor Resources (lower right) > Connect Asset Map

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WHAT'S NEW IN CHAPTER 2

Each chapter of *Macroeconomics,* 23rd edition, contains data updates and numerous revised examples that will be fresh and relevant for today's students. Chapter-specific updates include new boxed pieces, additional Key Graphs, and substantial revisions to the core content. The content and examples were also revised with a keen eye toward diversity, equity and inclusion.

Chapter 2: The Market System and the Circular Flow

This chapter contains two new Key Words (*coordination problem* and *incentive problem*), revised examples, increased clarity on the benefits of property rights, and a streamlined presentation of the circular flow model.

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TEACHING GUIDE: SUGGESTIONS FOR IMPLEMENTATION

The purpose of this Teaching Guide is to support you in the delivery of your chosen curriculum in either a face-to-face or online classroom format. It also was created to help you address some of the **following challenges in higher education:**

- Addressing the inability to measure student comprehension prior to major assignments such as a midterm or project.
- Overcoming the inability to tailor your lecture to the topics that students find difficult.
- Increasing student engagement by providing opportunities for them to apply the knowledge gained in the classroom to real-world scenarios.
- Providing students with opportunities for self-reflection outside of classroom activities.
- Increasing students' critical-thinking and problem-solving skills.

You will learn that we created many different teaching resources you can use either before, during, or after class. Because of the quantity of options, the goal of this implementation guide is to provide an overview of how you might select the many teaching resources at your disposal.

Need help getting started with Connect Economics?

Would you like a one-on-one consultation, please reach out to your McGraw Hill representative and they'll connect you with our implementation team. Please visit https://mhhe.com/rep to find your rep.

If you prefer self-guided help, please https://www.mheducation.com/highered/support/connect

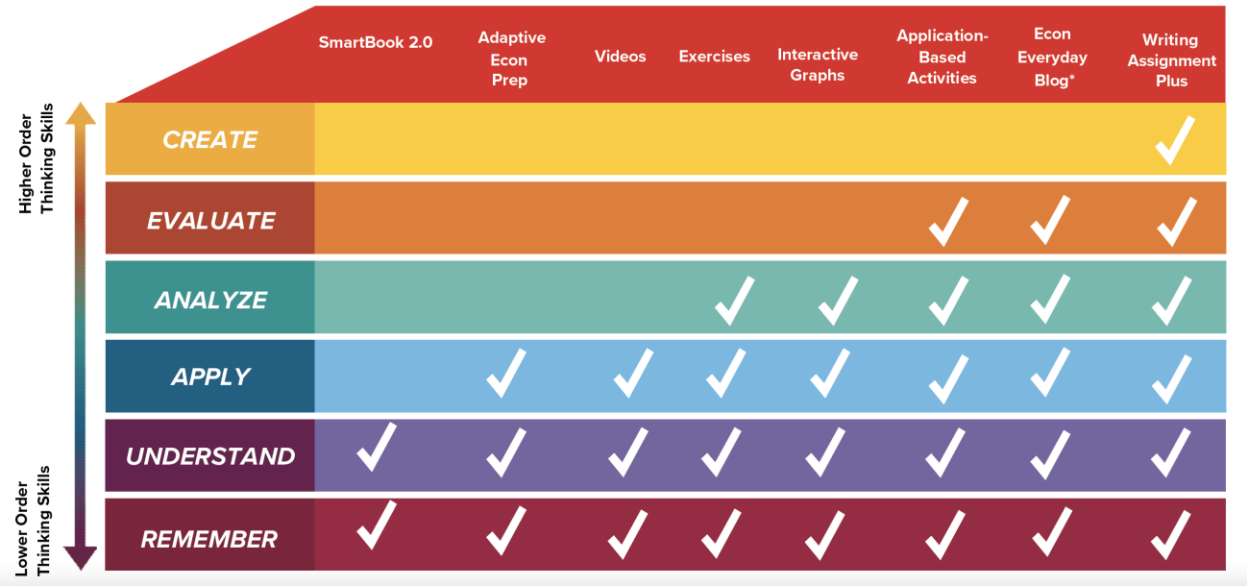
So, What Assets Can I Chose From?

The chart below shows a few of the key assignable economics assets with Connect® aligned with Bloom's Taxonomy. Take your students higher by assigning a variety of applications, moving them from simple memorization to concept application. Within Connect, we tag assessments accordingly so you can filter your search, assign it, and receive reporting on it.

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Generally, a typical class session for any course comprises three "touch points:" before, during, and after class. For a face-to-face course, your class session would normally be the day you lecture to students. For an online course, the class session would be when you recorded the lecture or when the live lecture is streamed on the Web.

Our teaching resources fall into ten categories:

- **SmartBook 2.0** SmartBook 2.0 makes study time as productive and efficient as possible. Students move between reading and practice modes to learn the content within the chapter. As they progress, the adaptive engine identifies knowledge gaps and offers up content to reinforce areas of weakness.
  Click path in Connect: New Experience > Assignments > Add Assignment > SmartBook 2.0
- **Narrated Lecture**s These videos give students a brief (15 minute) overview of the chapter content via narrated PowerPoint. These videos can be added to the course via zero point assignments
  Connect: New Experience > Assignments > Add Assignment > Question Bank > Chapter X > Narrated Lectures
- **Connect® Exercises** End-of-chapter exercises reinforce chapter content through a variety of question types including questions that make use of the graphing tool. Problems with algorithmic variations are also available.

  Click path in Connect: New Experience > Assignments > Add Assignment > Question Bank > Chapter X > Exercises
- **Application-Based Exercises (ABAs)** New immersive real-life scenarios engage students and put them in the role of everyday economists. Students

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practice their economic thinking and problem-solving skills as they apply course concepts and see the implications of their decisions as they go. Each activity is designed as a 15-minute experience, unless students eagerly replay for a better outcome.
Click path in Connect: New Experience > Assignments > Add Assignment > Application-Based Activity

- **"Connect the Dots" Videos** The "Connect the Dots" video series takes important economic concepts and explains them in an engaging, relatable manner. Patrick Walsh walks students through examples that help contextualize concepts in ways that make them easier to understand and apply. Each includes a related assessment item to test student understanding.
  Click path in Connect: New Experience > Assignments > Add Assignment > Question Bank > Course-Wide Content Dropdown Tab > Connect the Dots Videos (2.0, MHE)
- **Interactive Graph Assignments** These are designed to help students visualize and interpret economic concepts, graphs, and real data. All graphs are accompanied by assignable assessment questions and feedback to guide students through the experience of learning to read and interpret graphs and data.
  Click path in Connect: New Experience > Assignments > Add Assignment > Question Bank > Course-Wide Content Dropdown Tab > Interactive Graphs (2.0, MHE)
- **Adaptive Econ Prep: Math and Graphing** - Help your students remediate pre-requisite math skills for every economics concept in your principles course by assigning the new Adaptive math preparedness module specifically designed for each topic. Note that these are designed as supplementary assignments/ additional help with foundational math concepts. Math concepts build on each other so be sure to assign Adaptive Math Prep for supply and demand prior to assigning the one for elasticity for the best results. We suggest assigning zero points/low-stakes assignments, and perhaps making mastery a prerequisite to being able to complete the end-of-chapter homework assignments. You can either assign individual modules to accompany specific chapters or assign the entire tool as a review for students.
  Click path in Connect: New Experience > Assignments > Add Assignment > Adaptive Learning Assignment
- **Economics and Ethics Discussion Questions** Over 60 discussion questions that highlight the challenge of ethical decision making within the economic study of allocating resources. Set-up as multiple-choice questions without a correct answer, just an explanation to help spur discussion. All ethical dilemmas are wrapped around standard economic topics like price discrimination and scalping,

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the Edgeworth box and Pareto optimality, interest and usury outsourcing, environmentalism as a normal/luxury good, and more.
Click path in Connect: New Experience > Assignments > Add Assignment > Question Bank > Course-Wide Content Dropdown Tab > Economics and Ethics Discussion Questions (Beta, MHE)

- **TUCE Questions** Sixty multiple-choice questions designed to help students prepare for the standardized economics tests that target their knowledge of principles-level topics in economics.
  Click path in Connect: New Experience > Assignments > Add Assignment > Question Bank > Course-Wide Content Dropdown Tab > TUCE Questions (1.0, MHE)

Assigning SmartBook 2.0 and Connect Exercises

Connect gives you a wide array of flexibility in making assignments and creating grading policies. You may choose to:

- assign as many assignments as appropriate.
- determine point values for each question/application exercise individually.
- make available multiple attempts per assignment with options of accepting the highest score or averaging all the scores together.
- deduct points for late submissions of assignments (percentage deduction per hour/day/week/so forth) or create hard deadlines.
- show feedback on exercises/questions immediately or at your preference.
- provide for study-attempts to allow for completion of the assignment after the due date without assigning a point value.

Some recommendations include:

- Before selecting the option for one attempt only, select unlimited or multiple attempts on the first few assignments to allow students a chance to learn and navigate the system.
- Provide a low point value for each question because multiple questions are usually assigned for each chapter. A good rule of thumb would be to make “Test Bank Questions” worth 1 point each and “Connect Exercises” like the end-of-chapter Problems worth 5 to 10 points each because these require more time and thought.
- Select feedback to be displayed after the assignment due date to limit students from giving the correct answers to other students while the application exercise is still available.

So, When Do I Assign Each Type of Teaching Resource?

Wouldn’t it be wonderful if you could transition from simply assigning readings, lecturing, and testing to actually adapting your teaching to student needs? By utilizing the teaching resources outlined below during the three touch points, you can significantly

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impact students' learning and create a learning environment that is more engaging, involving, and rewarding. In other words, you can now tailor your classrooms to pinpoint and address critical challenges, thereby creating the greatest impact and assisting students develop higher-order thinking skills.

You can identify which of the other resources can be used with the Connect asset map. Click path in Connect: New Experience > Dashboard > Instructor Resources (lower right) > Connect Asset Map

Before Class

The learning goals we have for students determine our assignments before, during and after class. For example, you may want to focus on mastering content, applying content, or using content to solve problems. Alternatively, you may want to achieve all three goals.

A reading assignment—typically a chapter from the product in use—is a student's initial exposure to course content. Requiring students to complete a SmartBook 2.0 module either prior to class or an online lecture allows you to gauge their comprehension of the material. Having a better sense *before* class of which concepts your students are "getting" and which ones they are not, allows you to more effectively and efficiently plan your time with them *during* class. To ascertain student competency, use the reporting function of SmartBook 2.0, where you can view general results of their performance. Below is a screenshot of a general results report. This sample report for student Assignment Progress, Completion Time, Leaners' Metacognition and Challenging Concepts with the opportunity for the instructor to dig into the most challenging concepts/ learning objectives.

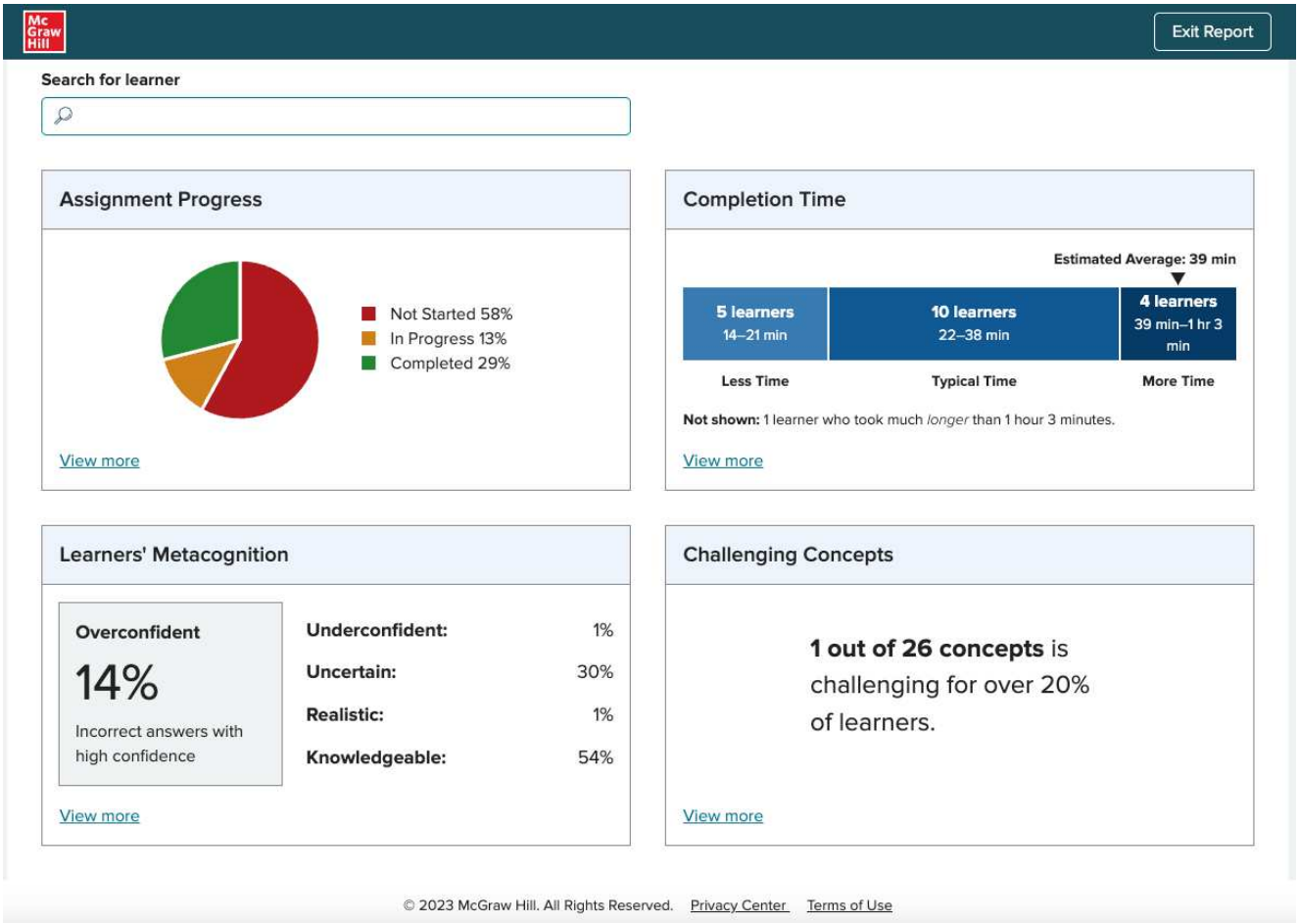
Click path in Connect: New Experience > Performance > Assignment results > select SmartBook assignment by assignment name > View report > in right column click on score

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Additionally, Connect® exercises, such as Problems, Review Questions, Discussion Questions, and Test Banks offer students a second exposure to important sections of the chapter after their completion of a SmartBook 2.0 assignment.

During Class

The Teaching Guide offers a host of additional materials and experiential activities you can use to bring chapter content to life.

Guided Peer Instruction (GPI)

This chapter is supported by Guided Peer Instruction questions. Please refer to the Instructor Resources in Connect to find the "Guided Peer Instructions Instructor's Manual" and "Guided Peer Instructions PPTs" with questions and solutions.

Click path in Connect: New Experience > Dashboard > Instructor Resources (lower right) > Guided Peer Instructions

When using GPI, students do some basic preparation as homework—reading and tackling the easier problems at home—and then come to class to work out more difficult problems while you're there to guide them in their analysis. What we want them to do in

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class is to think beyond the basics in the textbook or in the lecture and learn to think critically and apply economic concepts.

In GPI:

- In-class questions are meant to be harder than the basic homework questions
- We expect most students will get the questions wrong individually (30%–50% correct)
- We expect most groups will get the questions right (75%–85% correct)

Example question from biology:

> Think of a large oak tree. Where does most of the mass of the tree come from?
>
> A. The soil
>
> B. The water
>
> C. The atmosphere
>
> D. Sunlight

The answer is not at all obvious. But if you think long enough, you will perhaps realize that the correct answer is c, the atmosphere. That's because when the tree engages in photosynthesis, it uses sunlight to break up CO2 molecules from the atmosphere. The carbon from those CO2 molecules ends up forming the large majority of the mass of the tree.

However, the answer isn't necessarily important. From the pedagogical point of view, the point of this question is not to assess student understanding but to create it. It has a non-obvious answer that students can't get from just memorizing the book. The answer requires students to build on what they know and apply it. It makes them stretch from rote memorization to application and insight.

Other In-Class Activities

If your goal is content mastery and you are utilizing SmartBook 2.0, you can plan class activities and lecture based on results from the general results report and the metacognitive skills report. This allows for a more tailored class period that enhances student engagement and more opportunities to resolve gaps in knowledge.

If your goal is to jointly engage your students while applying content from the text, you can select a self-assessment follow-up activity (all follow-up activities are found in the Teaching Guide). These assets are especially useful if you are "flipping" your classroom, wherein the class session is used for application and analysis of key concepts rather than lecture.

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After Class

After the face-to-face class session, or online lecture, you can assign Connect® exercises as homework to further reinforce the material covered in the textbook and lecture. You may also want to assign a Connect the Dots video if you notice that students are struggling with a particular topic, even after class. To further gauge student comprehension, you can also assign a quiz or exam. The test banks in Connect® focus more on defining and explaining material, and the test banks focus more on application and analysis.

Finally, if you are looking to have students think critically to solve real-world problems, then you may want to utilize an application-based activity after class. Application-based activities are mini-simulations that allow students to make decisions and see their impact immediately. There are both theory-based questions that have right and wrong answers, and there are also branching questions that allow students to make ideal, sub-ideal, and incorrect decisions based on the theory they've learned. A student's particular path in the activity will depend on the decisions made on the branching questions. Application based activities should be utilized after a student has had at least one pass at the chapter content as they do not introduce new material. Rather, they encourage students to apply, analyze, and evaluate material they already understand.

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LEARNING OBJECTIVES

2.1 Define and explain laissez-faire capitalism, the command system, and the market system.

2.2 List the main characteristics of the market system.

2.3 Explain how the market system answers the five fundamental questions of what to produce, how to produce, who obtains the output, how to adjust to change, and how to promote technological progress.

2.4 Explain the operation of the "invisible hand."

2.5 Describe the mechanics of the circular flow model.

2.6 Explain how the market system deals with risk.

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OVERVIEW OF CHAPTER 2

This chapter begins with a brief comparison of the command and market systems, transitioning quickly to a discussion of the institutional framework of the American market system. Brief explanations are given for these characteristics of the market system: private property, freedom of enterprise and choice, the role of self-interest, competition, markets and prices, the reliance on technology and capital goods, specialization, use of money, and the active, but limited, role of government. The authors then address the Five Fundamental Questions faced by every economy and explain how a market economy answers each one. A discussion of Adam Smith's "invisible hand" leads into an explanation of why command systems have failed. This chapter also introduces the circular flow model as an overview of how resources and goods move through a market system. The final part of the chapter discusses how market systems deal with risk.

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COMMENTS AND TEACHING SUGGESTIONS

1. A surprising number of students do not really understand the characteristics of the American market system. Many students have no idea how prices are set and even after the chapter on supply and demand may still believe that most prices are determined by an external government agency or by producers arbitrarily.

2. In discussing the importance of private property, you may want to use the following Concept Illustration.

Concept Illustration – The "Berry Bikes" and Private Property

The following excerpt illustrates the importance of personal property rights to the "care and maintenance" of property. Where no such rights exist, property tends to get overused and abused.

The "Berry Bikes": A Lesson in Private Property[1]

Berry College is a private college located on a large campus adjacent to Rome, Georgia. In March 1998, the Berry College Student Government Association (SGA) used student activity funds to purchase 20 bicycles for student use on campus.

The bright red bicycles, each with an identifying plate reading "Berry Bike," were available to all students on a "first-come, first-served basis," making them a common property resource. The rationale for spending student fees was that the distance between some buildings on campus made getting to class on time difficult. Several factors would seem to favor the plan. The campus is relatively self-contained; it is unlikely that townspeople would enter college property to use the bikes or that students would ride them off campus where they would be abandoned, lost, or stolen.

Moreover, the student body is relatively small. Anyone who abused a bicycle could be readily identified, and the students harmed by having bicycles mistreated would not be strangers. These factors would presumably deter would-be vandals.

Unfortunately, the results of the Berry bike project were dismal. It took little time for the misuse of the bicycles to become evident. Writing in the April 2, 1998, *Campus Carrier*, student Liz Hill reported that "Chains have been broken, tires punctured, handlebars bent, and seats torn" after "only a couple of weeks." Recognizing the underlying cause of mistreatment, Hill implored students to "treat the bikes as if they were your own property." Evidently, her column spurred little change.

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[1] This anecdote is abridged from Daniel L. Alban and E. Frank Stephenson, "The 'Berry Bikes:' A Lesson in Private Property," *The Freeman*, October 1999, p 8-9. Reprinted with permission.

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On April 21, SGA President M. Lynsey Morris e-mailed all students that "It has come to our attention here in the SGA office that many students are failing to take care of the Berry Bikes…. These bicycles are top quality and should not be bending and breaking the way they are. The [SGA] officers and other students have seen many people riding the bikes at absurd speeds, doing tricks, and just abusing the bicycles in general." She too requested that students "treat [the bikes] as you would your personal property." Morris's appeal [also] apparently met with little success; a survey at the end of the semester revealed that four of the 20 bikes were lost or stolen and 11 were in a state of disrepair.

Undeterred, the SGA had the bicycles repaired over the summer recess and resumed the program in the fall. It soon became apparent that the abuse would continue. The September 10 *Campus Carrier* editorialized about "mangled corpses of twisted red metal that lie about campus" and concluded that "Perhaps SGA put too much trust in human nature and Berry students' respect for property." Was that the problem? Or was it that the SGA did not understand the role of incentives? Only a month into the new semester, the SGA suspended the program with the intention of leasing the remaining bicycles to students on a semester-by-semester basis, thereby alleviating the problems associated with common-property resources.

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3. If you haven't already talked about Adam Smith and his role in economics, this may be a good time to introduce the "father of economics." His emphasis on the role of self-interest in motivating economic activity is especially relevant here. You might place copies of the "Wealth of Nations" on reserve at the library to encourage students to sample the original work. You could use short excerpts as the basis for discussion or essays. "Adam Smith and the Wealth of Nations," a 28-minute video/film, is an excellent supplement. Check with your Federal Reserve District Bank's public information office or your nearest Center for Economic Education for availability.

4. Markets coordinate economic activity and changes in prices (products and resources) signal that changes have occurred within particular markets. A simple example of product X and product Y can be used. Assume an increase in the demand for X. This change will lead to an increase in the price of X, an increase in the profitability of X, an increase in the quantity supplied of X, an increase in the demand for the resources used to produce X, and an increase in the prices of those resources. Because of a limit in consumer income, the demand for Y is assumed to decrease followed by all of the changes that will occur in response to the decrease in the demand of Y. After all of these changes have occurred, explain how the transferable resources will move from Y to X. This illustrates the concepts of the "invisible hand."

5. This is a good time to reintroduce the concept of goods for the future from Chapter 1. In discussing the importance of producing goods for the future for the market system, remind the students of the impact upon the production of consumption goods in the present.

6. In discussing the use of money, the following Concept Illustration may be useful.

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Concept Illustration – Use of Money

Imagine a worker producing alternators for automobiles. At the end of the week, instead of receiving a piece of paper signed by the company, or a few pieces of paper engraved in green and black, the worker's pay consists of ten alternators. With no desire to hoard alternators, the worker ventures into the business district to spend this income on groceries, clothing, and a movie. Obviously, the worker is faced with some inconvenient and time-consuming trading, and may not be able to negotiate any exchanges at all. Finding an owner of a clothing store who needs an alternator can be a formidable task. And if the clothing does not trade evenly for the alternators, how do the parties "make change"?

Such an illustration may lead students to conclude that money is one of the great social inventions of civilization.

7. The five fundamental questions must be answered by all types of economic systems. Although the emphasis of this chapter is on the American market system, current economic changes in Russia and China and areas of the developing world can be discussed to illustrate how different types of economics answer these questions differently. Students tend to be fascinated with the contrasts between the former Soviet and American systems; the contrasts seem to make students more aware of aspects of capitalism that may have been taken for granted. In any case the instructor may want to supplement the chapter by assigning students to find current news items on the economies of the transitional economic systems of the former Eastern bloc countries. This helps to point out that the economizing problem and five fundamental questions are common to all societies, not just to capitalist systems. The CT "Korea by Night" is another example illustrating the contrast between command and market economies.

8. The CT "Bitcoins and Cheap Electrons" demonstrates the concept of least cost production. Bitcoin production facilities locate near low cost energy producers to minimize cost since Bitcoin mining is energy intensive.

9. When discussing the first two of the fundamental questions, ask who in the market economy are most responsible for answering each of the questions. Explain that the "Who will get the output?" question is an income distribution question and is determined by the distribution and productivity of the resources and the demand for the resources. Discuss how differing consumer dollar votes in the market for fast food workers and computer system workers determine the differences in the workers' wages and incomes.

10. Discuss how the three types of business entities (sole proprietorship, partnership, and corporation) deal with risk. In particular discuss how corporations offer their shareholders limited liability. Also discuss how insurance puts a price on risk as presented in the CT "Built on Sand."

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STUDENT STUMBLING BLOCK

1. This chapter introduces students to many important concepts and terms that will be expanded upon in later chapters. These concepts and terms are vital to the understanding of economics. Current event examples can be helpful.

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LECTURE OUTLINE

As opposed to providing a traditional outline, the author team would like to direct instructors to the McConnell 23e PowerPoints to serve as chapter outlines. The chapter PowerPoints offer the most organized outline of the chapter and can be downloaded from the Instructor's Resource page in Connect.

Click path in Connect: New Experience > Dashboard > Instructor Resources (lower right) > PowerPoint Presentation

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QUIZ

The following questions are unique to this Teaching Guide and cannot be found in Connect. They are included for instructors who want to provide in-class quizzes or otherwise have some chapter-aligned content available outside of Connect. Many additional auto-graded problems can be found in Connect and can be sorted by difficulty, learning objective, and other criteria.

1. Which statement best describes a command economy?

   A. The production of goods and services is determined primarily by markets, but the allocation of goods and services is determined primarily by government.
   B. The production of goods and services is determined primarily by government, but the allocation of goods and services is determined primarily by markets.
   C. The production and allocation of goods and services is determined primarily through markets.
   D. The production and allocation of goods and services is determined primarily through government.

   Answer: D

2. Which statement is correct?

   A. Freedom of choice and enterprise are essential elements of the market system.
   B. Producers are “kings” in a market economy because they determine what is produced.
   C. The market system is efficient at allocation of resources, but not consumer goods to their most valued uses.
   D. The operation of a market system eventually results in an equal distribution of income.

   Answer: A

3. In a competitive economy, prices:

   A. influence consumers in their purchases of goods and services.
   B. influence businesses in their purchases of economic resources.
   C. influence workers in making occupational choices.
   D. do all of these.

   Answer: D

4. The competitive market system:

   A. encourages innovation because government provides tax breaks and subsidies to those who develop new products or new productive techniques.

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B. discourages innovation because it is difficult to acquire additional capital in the form of new machinery and equipment.
C. discourages innovation because firms want to get all the profits possible from existing machinery and equipment.
D. encourages innovation because successful innovators are rewarded with economic profits.

Answer: D

5. Which is *not* one of the Five Fundamental Questions?

A. How will the goods and services be produced?
B. How should the system accommodate change?
C. Who is to receive the output of the system?
D. What goods and services should be produced by government?

Answer: D

6. The idea that firms and resource suppliers in seeking to further their own self-interests in a competitive market economy also simultaneously promotes the public or social interest is a description of:

A. The guiding function of prices
B. Capital accumulation
C. The “invisible hand”
D. “Dollar votes”

Answer: C

7. Which of the following is a limitation of the simple circular flow model?

A. product markets are ignored
B. resource markets are ignored
C. the determination of product and resource prices is not explained
D. households are included, but not businesses

Answer: C

8. Households and businesses are:

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

Answer: C

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9. The influential book written by Adam Smith was:
   A. *The Worldly Philosophers*
   B. *The Wealth of Nations*
   C. *The Age of the Economist*
   D. *The Affluent Society*
   Answer: B

10. The circular flow model:
   A. Assumes that central planning is taking place
   B. Illustrates how natural resources are created
   C. Illustrates how money is created by the banking system
   D. Illustrates the interdependence of businesses and consumers
   Answer: D

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