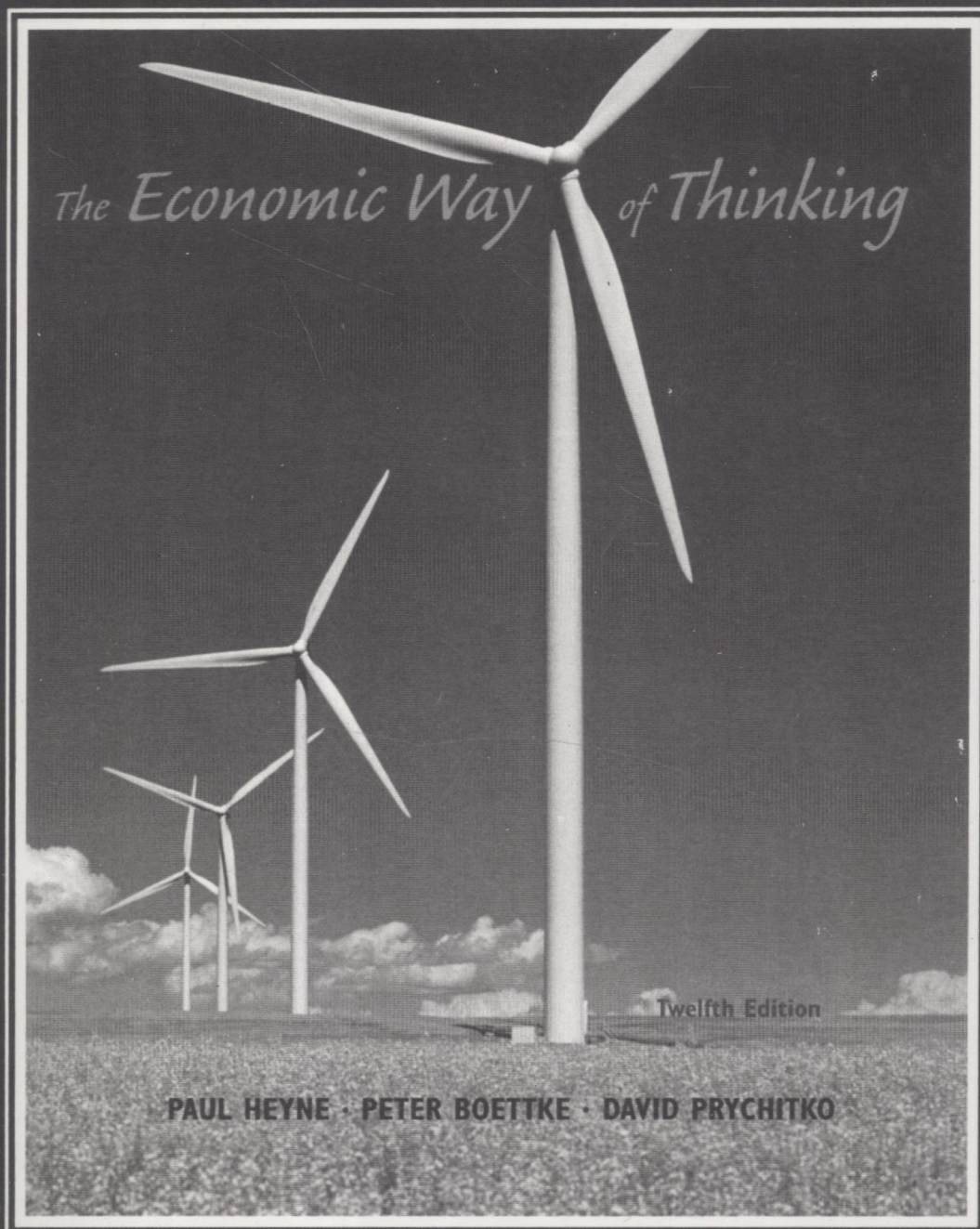


Study Guide



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PEARSON

STUDY GUIDE

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The Economic Way of Thinking

12e

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Preface to the 12th Edition Study Guide

This study guide serves several purposes.

The guide adds more material than we've covered in the textbook chapters. You will find the multiple choice questions in Part A rather difficult. Don't be discouraged if you get a few of them wrong on your first attempt because we offer additional discussion of each correct answer in Part B.

Part C offers multiple choice questions that serve as a quiz. Correct answers (without explanation) are offered in Part D.

The remaining Parts E through H offer you the opportunity to try your hand at mini-essays. Even if your professor doesn't administer essay-based exams; the questions in these sections will be helpful to read.

Finally, we offer Part I. It is a blank portion for you to write down any questions you might consider asking your instructor to clarify or explain.

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CHAPTER 1

The Economic Way of Thinking

A. MULTIPLE-CHOICE QUESTIONS ON THE PRINCIPAL IDEAS OF CHAPTER 1

1. Economic theory began with efforts to understand why it was that many diverse individuals, pursuing their own interests on the basis of extremely limited information,
 - A. cooperated more effectively when they were selfish than when they tried to behave generously.
 - B. could not coexist peacefully in the absence of an independent government to arbitrate their disputes.
 - C. managed to cooperate extensively in mutually beneficial ways.
 - D. preferred continued social chaos to an ordered, planned society.

2. The system of plan coordination described by economic theory is one in which
 - A. consumers are supreme.
 - B. producers control both output and prices.
 - C. producers decide what kinds of goods will be available, and consumers decide how much ought to be produced.
 - D. people adjust to one another's actions by responding to the changing relative advantages that they perceive in the various opportunities open to them.

3. Which one of the statements below best summarizes the economic way of thinking about social behavior? Social behavior
 - A. can be predicted from knowledge of the biological, cultural, and psychological factors that determine it.
 - B. is determined by the interactions of the three major groups in society: consumers, business, and government.
 - C. is the outcome of the incentives created by the "rules of the game".
 - D. is determined by a continuous battle for domination between the wage-earning class and the class made up of large property holders.

4. The use of theory to explain or predict the coordination of an economic system
 - A. enables students of economics to avoid the biases that might otherwise distort their thinking.
 - B. will lead to wrong results unless the theory is based entirely upon close observation.
 - C. leads to many conclusions that are correct in theory but false in the real world.
 - D. is unavoidable because all efforts at understanding are rooted in some theoretical framework.

B. ANSWERS TO AND EXPLANATIONS OF MULTIPLE-CHOICE QUESTIONS ON THE PRINCIPAL IDEAS OF CHAPTER 1

1. C. Economic theory, in assuming that people pursue their own interests, doesn't assume that those interests are necessarily selfish or materialistic. Nor do people as a rule cooperate more effectively when they're selfish than when they're generous. But economic theory does show how a great deal of effective cooperation can occur in the presence of very little generosity and also without a great deal of government guidance and control. It explains the surprising fact that order and not social chaos is found in the absence of an authoritative, national economic plan.
2. D. The three other options are much too simplistic. Some people certainly have more power and control than others do. But the process in which consumers and producers coordinate plans is essentially a mutual adjustment process. Money prices are the key signals. Participants in the economic process alter their behavior largely in response to the changed pattern of relative prices created by the continually changing behavior of others. We will try to develop this idea in the next several chapters of the text.
3. C. The economic way of thinking assumes that consequences are the result of people's choices, that only individuals make choices, that their choices are reasoned—in the sense that people compare expected benefits and costs—and that these choices are largely coordinated through markets of many sorts. "Market" in this context is simply a name for the adjustment process through which people's various interests are made mutually compatible. If that sounds too wordy or abstract, think of the market as the main way that people in commercial society coordinate their production and consumption plans. By the way, students often confuse the terms "economy" and "economics," so we might as well also clarify that right now. The economy (or economic system) is a set of *institutions* (rules, practices, customs) that allows people to coordinate their production and consumption plans. In commercial society, people coordinate plans through market exchanges. The term "economics" refers to the *theory* – the approach – we will develop in this book to *explain* and *understand* how the reasoned choices of individuals affect, and are affected by, the economy.
4. D. Some theory is unavoidable, because without a theory we don't know what we're observing or what to look for. Good theories are intimately connected with observations of the phenomena they try to explain but can never be based exclusively on observation because observation itself is always guided by theory. Every theory is a partial perspective, which means that it emphasizes some factors while slighting others. This means that every theory contains some biases. Students beginning the study of economics are invited to view the world from a perspective developed over many years by economists; they receive no guarantee that this is the only valid or even the best perspective. But since the test of any theory is its ability to make sense of the real world, no theory can be called correct if it proves false or misleading when applied to actual events.

C. CHAPTER 1 QUIZ

1. The text maintains that people find the workings of the economic system bewildering, largely because
 - A. they notice the economy only when it's malfunctioning, but the principles by which a system works are best exposed when the system is functioning properly.
 - B. they don't like to be reminded of economic problems and so lose many opportunities to learn from looking closely at the causes and consequences of economic failures.
 - C. an economic system is such a complex way to coordinate plans that it can be understood only with the aid of mathematical theories that are beyond most people's comprehension.
 - D. everything depends on everything else, so that nothing can be understood until the system is grasped in its entirety.

2. The movement of rush-hour traffic demonstrates that
 - A. detailed regulations directing each person's behavior are necessary to secure cooperation when large numbers of people are involved.
 - B. people's pursuit of their own interests while paying little or no attention to the interests of others doesn't necessarily produce conflict.
 - C. general rules or laws are not necessary for a society to function effectively.
 - D. people place a very low value on safety.

3. If traffic is to flow smoothly, which pieces of knowledge are important for each motorist to have?
 - A. The position, direction of movement, and velocity of a few cars in the immediate environment
 - B. The rules of the road (stop at red lights, drive to the right, etc.)
 - C. Both of the above
 - D. The destination of other drivers in the immediate environment and the urgency of their trip
 - E. The number of drivers expected to be on the road during the time in question and their preferred routes

4. If we are to achieve the benefits of civilized life, people must be allowed to cooperate with one another by engaging in certain very specific acts at exactly the right time and place
 - A. because people tend to think only of themselves.
 - B. regardless of how selfish or selfless people are.
 - C. unless they love one another.
 - D. unless they want to rely on government.

5. In *The Wealth of Nations*, published in 1776, Adam Smith tried to show that
 - A. the constant attention of government was an essential precondition for effective cooperation among the members of a society.
 - B. social cooperation became impossible among the members of a society if government tried to regulate it in any detailed way.
 - C. people often were capable of cooperating effectively even when government policies tried to prevent them from doing so.
 - D. wealth was produced more by selfish behavior than by altruistic behavior.

6. What the text calls "the economic way of thinking" is primarily

- A. a body of statistical data.
 - B. a set of historical generalizations.
 - C. concerned with theory and ignores all relevant facts.
 - D. a method or testable approach rather than a dogma.
7. Economic theory assumes that
- A. individuals choose those actions from among the options available that they think will yield them the largest net advantage.
 - B. people are selfish in the final analysis.
 - C. everyone is more interested in money than in other goods.
 - D. there's no difference between people at all.
8. Economic theory would be much less successful than it is in predicting the consequences of particular actions if
- A. almost everyone in the society makes no choices but instead "let things happen".
 - B. economists hold powerful positions in government.
 - C. people's shared customs are ultimately the same.
 - D. people's incomes are very different.
9. The process of flow coordination that economic theory describes is called a "mutual adjustment process" because
- A. no one has any more power than anyone else.
 - B. the actions that people take create the options for others.
 - C. everyone derives as much benefit from it as everyone else.
 - D. it leads to the greatest good for the greatest number.
10. Economic theory explains, to some degree,
- A. the workings of the business sector of society.
 - B. the workings of the government sector of society.
 - C. the behavior of consumers.
 - D. all of the above.
11. Economic theory explains the process of "economizing", which is the process of
- A. allocating scarce resources in a way that offers from them the most of what the economizer wants.
 - B. getting by with as little as possible.
 - C. persuading other people to pay as many as possible of the costs that the economizer's actions create.
 - D. saving as much of one's income as is reasonably possible.
12. The central problem that makes "economizing" necessary is
- A. capitalism.
 - B. ignorance.

- C. scarcity.
 - D. selfishness.
 - E. superstition.
13. The core problem that economic theory faces when it tries to explain the interactions of people in a society is
- A. the high prices of oil and gasoline.
 - B. the many diverse individual projects and plans that have to be coordinated.
 - C. greed.
 - D. the love of money as opposed to the love of one's neighbors.
14. What did Adam Smith mean by the phrase "a commercial society"?
- A. A society in which business people, or what Smith called "merchants and manufacturers," dominate the culture
 - B. A society in which making money is the most important concern in almost everyone's life
 - C. A society in which religious and national holidays become nothing more than opportunities to make money
 - D. A society in which specialization has been carried so far that everyone lives by exchanging
15. Automobile drivers using the streets of a large city usually manage to reach their destinations without any collisions because almost all motorists
- A. pay strong attention to the rules of the game of traffic.
 - B. share the same goals.
 - C. value safety more than speed.
 - D. want to avoid collisions.
16. "Property rights" can usefully be thought of as
- A. characteristics exclusively of the private sector in capitalist economies.
 - B. obstacles to government coordination of the economy.
 - C. rules of the game that facilitate social cooperation.
 - D. social institutions that create additional uncertainty.
17. What happens when "the rules of the game" in a society are in dispute or inconsistent or highly unclear for other reasons?
- A. Social cooperation breaks down.
 - B. Less voluntary exchange occurs.
 - C. Conflict increases.
 - D. All of the above occur.
 - E. None of the above occurs, but rather people become more considerate of others because they want others to be considerate of them.
18. The argument that we ought to approach every question with a completely open mind is
- A. excellent advice even if we often have difficulty following it.
 - B. a problem because a completely open mind is a theory-less mind.
 - C. accepted by almost all economists.

D. only accepted by true liberals.

D. ANSWERS TO CHAPTER 1 QUIZ

- | | | | | |
|------|------|-------|-------|-------|
| 1. A | 5. C | 9. B | 13. B | 17. D |
| 2. B | 6. D | 10. D | 14. D | 18. B |
| 3. C | 7. A | 11. A | 15. D | |
| 4. B | 8. A | 12. C | 16. C | |

E. MUTUAL ADJUSTMENT AND CENTRALIZED COORDINATION

Is it really wise to permit all the drivers who use the freeway to choose for themselves the lane in which they will drive? What if 80 or 90 percent of them just happened to decide one morning that they all wanted to drive in lane four? Wouldn't it be better to assign numbers to motorists as they enter the freeway and thereby *guarantee* that they'll distribute themselves evenly across the lanes? Better safe than sorry—right?

1. Even without cellular phones, drivers are in communication with each other. How would their communication system handle the potential problem if 90 percent of the drivers entering the freeway on a given morning were thinking, "Today I'm going to drive in lane four"?
2. How could a lane-assignment system be enforced?
3. How does the present system handle the problems created by very slow drivers or stalled vehicles in a particular lane? How might the assigned-lane system handle it?
4. What's going to happen to Cleveland and Los Angeles, respectively, when everybody finally realizes how much more pleasant the weather is in southern California than along the southern shore of Lake Erie?

F. ANSWERS TO QUESTIONS IN SECTION E

Entering drivers would find themselves making such excellent progress in the other three lanes that they would quickly abandon their resolve. And drivers who were already in the fourth lane would leave it in response to the perceived advantages of the other lanes.

1. There would be no enforcement problems if all the drivers were perfectly satisfied with their assignments. But that would hardly ever be the case, given the different distances the drivers plan to travel, their varying skills and temperaments, and the inevitable advantages that some lanes would turn out to have at a given time and place. Allowing drivers to change lanes when they are *not* satisfied would, in practice, restore the present system. But *not* allowing them to do so is futile in the absence of an enforcement system. A lane-control system increasingly being used on urban freeways prohibits all but car-poolers from using a reserved lane. Enforcement problems have arisen even in this case, in which it's relatively easy for traffic officers to see whether a vehicle contains two or more passengers. Moreover, car-pool lanes are notoriously underutilized.
2. Under the present system, drivers behind the slow or stalled vehicle try to move into another lane. A slow vehicle in lane four will produce a diversion of traffic into lane three; the resulting slowdown in lane three will cause some movement into lane two. Drivers pursue their own plans, using whatever skills they possess, plus available information on the position and velocity of nearby cars. It is hard to conceive of any better way in which the assigned-lane system could

handle such problems. Contrary to what many suppose, centrally directed systems for securing social coordination are often not superior in “emergencies.” Mutual adjustment processes may demonstrate their superiority most decisively in situations characterized by unexpected problems.

3. A substantial move of people away from Cleveland to Los Angeles would change the relative advantages of living in each city. Think of the effects that such a migration would have on job opportunities, real estate prices, and congestion. The question is designed to make you see that Americans decide where to live and work by participating in a vast mutual adjustment process. Quite a few questions that begin “What if *everyone* decided to . . .” dissolve once we see that people actually decide on the basis of the changing net advantages created by the decisions of everyone else. Everyone would *not* make such a decision because the first such decisions would change the relative advantages perceived by later decision makers.

G. QUESTIONS TO THINK ABOUT

1. Who are some of the people whose cooperation helps you make it to and through your first class in the morning? Do you make predictions about their behavior? On what basis, or with what combination of empirical observation and theory?
2. What would happen if you reject what the text refers to as the major “biases” of economic theory? For example, how would you proceed if you decided to predict or explain events in society on the assumption that people do not really make choices but rather respond to stimuli in a strictly determined way? What are the consequences of dropping the assumption that other people’s behavior is *reasoned* behavior, taking account of expected benefits and costs?

H. ANSWERS TO QUESTIONS IN SECTION G

1. If you had breakfast or even a cup of coffee, you benefitted from extensive cooperative activities. Did you predict that someone would get up early in order to prepare the coffee? You did if you predicted that freshly brewed coffee would be waiting when you arrived in the cafeteria. If you took the bus to school, you probably predicted that the driver would adhere closely to the printed route and schedule. Your confidence in this prediction was surely not a result of simple observation. You worked with a theory. It assumes that bus drivers, like almost everyone else, find it in their interest to obey company rules when they have little or nothing to gain from disobeying them. You concluded that whoever happened to be driving your bus this morning would decide to stop at your corner fairly close to the usual time.
2. You probably couldn’t survive very long without the knowledge that you gain as a result of assuming that people *choose* their actions and that improving the benefits or increasing the costs of a particular action affects people’s behavior. When we find someone who does not seem to be responding to the costs and benefits that influence almost everyone else, we call that person “disturbed.” We might more accurately call such people *disturbing*: they disturb *us* because we cannot understand, explain, or predict their behavior.

I. QUESTIONS FOR YOUR INSTRUCTOR

CHAPTER 2

Efficiency, Exchange and Comparative Advantage

A. MULTIPLE-CHOICE QUESTIONS ON THE PRINCIPAL IDEAS OF CHAPTER 2

1. An activity is “economically efficient” if
 - A. it is undertaken with zero cost.
 - B. it creates material objects.
 - C. the chooser believes the activity is worthwhile.
 - D. the additional costs of the activity outweigh the additional benefits.

2. Does trade create wealth?
 - A. Yes, because trade makes available to people more of what they value
 - B. Yes, because trade only means the production of more material goods
 - C. No, because trade does not cause anything new to be created
 - D. Yes, but only for the one party in an exchange that takes advantage of the other party.

3. An informed and voluntary exchange is an exchange of equal values
 - A. or it leaves one party worse off than before.
 - B. if it is a fair exchange.
 - C. on all occasions.
 - D. on no occasions.

4. If Willie Loman has a comparative advantage in selling over repairing, this means that
 - A. Willie can obtain more of what he wants by specializing in selling and then trading for repair services.
 - B. the value of what Willie obtains relative to what he gives up in the process is greater when he sells goods than when he repairs them.
 - C. some other producer with whom Willie is able to trade has a comparative advantage in repairing over selling.
 - D. all of the above are the case.

5. Someone who has a strong “comparative advantage” in producing pottery will benefit from
 - A. increases in the efficiency of others who also have a comparative advantage in producing pottery.
 - B. reduced efficiency on the part of those who produce goods other than pottery.
 - C. a decline in the number of pottery that exchange for a fixed quantity of other goods.
 - D. a fall in the demand for pottery.

6. Lu Thier is an accomplished violin and viola maker. He can make either 6 violins or 6 violas each year, or a combination such as 3 violins and 3 violas. Which statement below is true?
- The opportunity cost of producing 1 violin is 1 viola.
 - The opportunity cost of producing 1 violin is 3 violas.
 - The opportunity cost of producing 1 violin is 6 violas.
 - The opportunity cost of producing 1 violin is 9 violas.
7. Efficient social cooperation and plan coordination among the participants in an economic system is promoted when
- everyone attempts to maximize leisure.
 - everyone attempts to minimize energy consumption.
 - people refrain from pursuing their comparative advantages.
 - people receive correct information about relative costs along with incentives to take these costs fully into account in making their decisions.
8. Middlemen serve an important function in a market economy because they
- channel their greed into good things for others.
 - are concerned with creating jobs in the economy.
 - love their work, and thereby help the overall performance of the economy.
 - produce valuable information that lowers transaction costs among producers and consumers.

B. ANSWERS TO AND EXPLANATIONS OF MULTIPLE-CHOICE QUESTIONS ON THE PRINCIPAL IDEAS OF CHAPTER 2

- C. If a chooser believes that an activity is “worth it” (i.e., that it is a worthwhile undertaking), then that activity is economically efficient in the eyes of that chooser.
- A. Wealth can be created without the fabrication of material objects. A mere swapping of used goods (recall the Jack and Jim story in the text) creates wealth for those traders.
- D. Two adequately informed people would not voluntarily exchange unless *both* expected to obtain more in value than they were giving up. Why does the notion persist that a fair exchange is an exchange of *equal* values? That’s an interesting question to think about.
- D. All three statements are attempts to summarize the same situation. The key is *available opportunities*.
- C. The price of pottery and hence the income of potters rises when fewer pieces exchange for the same quantity of other goods. Such an improvement in the terms of trade could come about through lower output by other potters as a result of decreased efficiency, through increased efficiency and hence higher output on the part of those who produce other goods, or through a change in people’s tastes that increases the demand for tile.
- A. He can make 6 violins *or* 6 violas each year, or a combination such as 3 violins *and* 3 violas. If 6 violins come at the sacrifice of making 6 violas, then one violin comes at the sacrifice of making 1 viola. It’s a one-for-one tradeoff. So the opportunity cost of producing 1 violin is one viola.

7. D. Much of the current controversy over what is efficient and what isn't arises because relative prices *accurately* reflect evaluations that some people strongly disapprove of. It is a troublesome truth that any evaluation of an economic system will be in part an evaluation of the values of the people who comprise it.
8. D. Middlemen tend to have a "comparative advantage" in information production. They have an ability to organize trades in a way that is cost-effective for both producers and consumers. That's why millions of people often choose to use the services of middlemen – it lowers their transaction costs.

C. CHAPTER 2 QUIZ

1. In the economic way of thinking, a "good" is defined as
 - A. anything in which having more of it is preferred to having less.
 - B. anything in which having less of it is preferred to having more.
 - C. anything that is manufactured.
 - D. anything that everybody in society agrees is valuable.
2. What is the difference between a "free" good and a "scarce" good?
 - A. There is no difference.
 - B. A free good can only be obtained by sacrificing something else of value; a scarce good can be obtained at no sacrifice whatsoever.
 - C. A scarce good can only be obtained by sacrificing something else of value; a free good can be obtained at no sacrifice whatsoever.
 - D. Free goods never have prices associated with them; scarce goods always have a price.
3. Technological efficiency, defined in terms of completely measurable relationships, is
 - A. easier to measure than is economic efficiency.
 - B. more important in the long run than economic efficiency.
 - C. a confused concept because efficiency is always a relationship between evaluations.
 - D. the key to rapid economic growth.
4. A student who decides to drive to work rather than take the bus
 - A. is behaving inefficiently.
 - B. decides that driving is more efficient for her.
 - C. is probably paying attention to personal comfort and convenience rather than efficiency.
 - D. is wasting our planet's scarce resources.
5. An office worker who estimates that he would save money by driving to work rather than taking the bus, but who chooses to take the bus because driving in rush-hour traffic frightens him, is
 - A. behaving inefficiently.
 - B. choosing what is for him the most efficient way to commute.
 - C. rejecting economic efficiency for personal reasons.
 - D. wasting scarce resources.
6. Is cutting down a tree in 2 hours with an ax more efficient than cutting it down in 10 minutes with a gasoline-powered chain saw?

- A. No, because time is valuable
 - B. Yes, because hand tools conserve nonrenewable energy resources
 - C. It could be, if the person cutting down the tree places a high enough value on using the ax.
 - D. There is no way to answer the question
7. "Material" wealth cannot be distinguished in any useful way from wealth in general
- A. all wealth consists ultimately of valued events or experiences.
 - B. wealth is ultimately whatever can be purchased with money.
 - C. material objects rarely contribute and are certainly not essential to the creation of wealth.
 - D. we are a thoroughly materialist society.
8. The word "productive", as applied to agriculture or manufacturing,
- A. merely implies that they are capitalistic producers.
 - B. cannot properly be applied to trade because mere exchange is not productive.
 - C. applies equally to trade because exchange is productive in the same ways that agriculture and manufacturing are productive.
 - D. is misleading because neither creates genuinely new material.
9. An activity is productive if it
- A. adds to the number of material objects.
 - B. creates wealth.
 - C. increases people's money income.
 - D. reduces the use of nonrenewable resources.
10. Can a successful novelist produce a house with a typewriter?
- A. Only if the typewriter is used to pound in nails
 - B. Of course not
 - C. Yes, by writing a novel and exchanging it for money that is then exchanged for a house
 - D. Yes, but only a paper house, which won't be very durable
11. If the people who patronize a particular post office branch collectively place a value of \$500 on the time they spend each day standing in line and one additional clerk who could be hired for a total cost of \$100 per day could eliminate that line, is the post office branch being managed inefficiently?
- A. Yes, because an output valued at \$500 could be obtained with an input valued at \$100.
 - B. Yes, because standing in line is a deadweight cost.
 - C. No, because government activities are not properly evaluated with money.
 - D. From the perspective of the customers the operation may seem inefficient, but the present arrangement must be deemed efficient from the perspective of the branch manager, who has chosen not to hire an additional clerk.
12. Fill in the blank: _____ cost refers to the next-best option a person gives up when making a choice.

- A. Accounting
 - B. Objective
 - C. Efficient
 - D. Opportunity
 - E. Regrettable
13. There is *no* opportunity cost of obtaining
- A. a free good.
 - B. a scarce good.
 - C. any good that a person acquires, as long as they value it highly enough.
 - D. any good that a person acquires, as long as they think it is worth the effort.
14. The absolute or ultimate measure of value in the opportunity-cost perspective
- A. is labor embodied in goods.
 - B. is natural resources consumed.
 - C. is leisure given up.
 - D. does not exist.
15. The production possibilities frontier assumes
- A. a given set of resources.
 - B. only one good can be produced from a given set of resources.
 - C. resources are free.
 - D. there are no opportunity costs of production.
 - E. all of the above.
16. The production possibilities frontier is used by economists to illustrate
- A. the strictly financial costs of production.
 - B. the opportunity costs of production.
 - C. the strictly financial benefits of production.
 - D. the opportunity benefits of production.
17. Can a person become a less efficient producer of one good if over time she becomes a more effective producer of a second good?
- A. No, because greater productivity must increase efficiency
 - B. No, but that might make the person choose to stop producing the first good
 - C. No, because more is always better than less
 - D. Yes, because the cost of producing the first good depends in part on the person's ability to produce the second good
18. The least expensive option (using money) is the most efficient option
- A. from the standpoint of society as a whole.
 - B. because efficiency is basically an economic concept.