

1. Explain what is meant by a command economy.

Ans: The command economy is the opposite extreme alternative to pure capitalism. It is a system characterized by government ownership of all or nearly all property resources and centrally planned and administered production.

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Learning Objective: 2.1

2. Explain the term “laissez-faire capitalism.”

Ans: Pure capitalism is sometimes called “laissez faire” capitalism which is a French term for “let it be.” In pure capitalism the government's role is limited to protecting private property and establishing the legal framework for free enterprise and free markets to function.

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Learning Objective: 2.1

3. List nine characteristics of the market system.

Ans: The nine characteristics discussed in the text are: (1) private property; (2) freedom of enterprise and choice; (3) self-interest as the major motivation for economic activity; (4) competition among buyers and sellers; (5) reliance on the market (price) system; (6) the use of advanced technology and large amounts of capital goods; (7) specialization; (8) the use of money rather than barter; and (9) active but limited role for government

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Learning Objective: 2.2

4. Why is the right of private property an essential characteristic of a market system?

Ans: Property rights are important because they give people private ownership of resources. This ownership encourages them to make the best use of those resources because they will benefit if they do. Property rights also encourage people to take the risk of investing in capital goods or to develop new innovation or products because they will receive the benefits from this activity if they are successful. Property rights offer incentives for people to maintain their property to preserve its value and invest in it if they think they can increase its value. Property rights also facilitate exchanges by making clear who owns a resource so that there is no question about the legitimacy of the transaction.

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Learning Objective: 2.2

5. What roles do freedom of enterprise and freedom of choice play in capitalism? How important are they to the operation of a competitive market economy?

Ans: In capitalism, two essential freedoms are the freedom of enterprise and freedom of choice. Business must be free to get economic resources, organize them to produce products, and sell them in the market. Businesses must also be free to enter or leave an industry. Freedom of choice gives business owners, resource owners, and consumers freedom to act to advance their own self-interest. Business owners are free to buy and sell property. Labour resources (workers) can enter or exit any line of work for which they are qualified. Consumers are free to purchase goods and services as they choose based on their budget constraints. Without these freedoms it would be impossible for a market economy to exist.

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Learning Objective: 2.2

6. Explain the importance of self-interest in the operation of a market system.

Ans: Self-interest is the motivating force behind both the demand and supply sides of the product and resource markets in a capitalist system. Entrepreneurs engage in production with the expectation of making a profit; workers seek the best wage and working conditions they can get; consumers allocate their spending in order to maximize their satisfaction.

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Learning Objective: 2.2

7. What is the importance of competition in relation to self-interest in a market system?

Ans: Competition is important as the force, which tempers or regulates the self-interest of producers, sellers, workers, and buyers. If producers make too much profit, competitors will arise to take advantage of the opportunity and as production increases, prices and profits will fall. If workers demand too much, employers will seek other workers who are willing to work for less. If buyers are not willing to pay a fair price for the product, producers will sell the product to someone who is. In each case it is competition or the threat of competition that tempers the potential abuse of economic power.

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Learning Objective: 2.2

8. What conditions are necessary for economic competition to exist?

Ans: Competition requires the presence of large numbers of buyers and sellers. The number must be large enough so that no single buyer or seller can affect the price of the product by their individual actions regarding demand or supply. In addition, competition assumes that it is simple for producers to enter or leave a particular industry so that the economy can adjust appropriately to changes in consumer demand, technology, or resource supplies.

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Learning Objective: 2.2

9. Explain why the market system is an organizing mechanism.

Ans: Markets and price give the economic system its ability to coordinate millions of economics decisions made on a daily basis. The system is an extensive communication network for expressing the wishes of consumers to producers. The price signals given by markets direct resources to the goods and services people want and indicate where profits are to be made for producers. Producers who fail to heed the market signals are punished. Consumers also use the market price to figure out how to make the best use of their limited incomes.

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Learning Objective: 2.2

10. Respond to the following question: “Producing capital goods takes time, so how can that be a more efficient form of production of consumer goods?”

Ans: The production of capital goods does require time. These capital goods, however, can then be used to increase the production of consumer goods. This roundabout method of production is more efficient over time, but it does not come without a cost. As shown by the production possibilities curve, resources used to make capital goods must be diverted from the production of consumer goods today to produce capital goods that will then be used to increase the consumer goods of tomorrow.

Page: 35 (and 18-19)

Learning Objective: 2.2 (and 1.7)

11. Describe two types of specialization in production.

Ans: Specialization may be of the human form with division of labour where different workers perform different production tasks; or it may be geographic specialization where some goods and services are produced in certain regions and others are produced in other areas.

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Learning Objective: 2.2

12. What are the economic advantages of the division of labour?

Ans: The advantages come from increased productivity or output per worker as specialized workers gain skills in performing one task and avoid loss of time in switching from one task to another. Therefore, more is produced with the same amount of resources as before specialization.

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Learning Objective: 2.2

13. Describe three ways that the division of labour contributes to society's output.

Ans: First, specialization lets people take advantage of differences in skills and abilities so they can be more efficient and productive. Second, specialization fosters learning by doing so people can become good at a particular task. Third, specialization saves time because people do not have to switch from one task to another.

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Learning Objective: 2.2

14. What advantage does a money economy have over a barter economy?

Ans: Trade is difficult with barter because it requires a coincidence of wants. Money overcomes that problem. A buyer can obtain goods without having to locate a seller who desires what the person has to trade. All products can be priced and traded on a common basis. Also, with money, neither party needs to carry products around with them so they are always available for trade. Money facilitates the exchange of products, which is necessary for specialization. Economic efficiency is improved with a system of money.

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Learning Objective: 2.2

15. How does the use of money differ from the use of barter in the exchange of goods and services?

Ans: Barter requires a coincidence of wants. In order for exchange to take place both parties have to want what the other is offering. Money, on the other hand, acts as a medium of exchange in that the appropriate quantity of it is generally acceptable in exchange for any good or service.

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Learning Objective: 2.2

16. What is money and what important function does it perform? Explain how it overcomes the disadvantages associated with barter. What conditions are necessary for people to accept paper currency in exchange for the goods and services, which they sell?

Ans: Money is anything that is generally acceptable as a medium of exchange. In Canada, money includes currency, coins, and chequable deposits.

Barter requires a coincidence of wants between the two parties to a transaction. Each has to want what the other has to offer. Money makes this coincidence unnecessary, as the seller is willing to accept money in exchange for goods or services offered and can, in turn, exchange the money earned for other goods and services from another seller. The necessary condition for the use of paper currency is that it must be generally acceptable. Sellers must have faith that the currency will have value when they want to use it to buy goods and services for themselves.

Note that the money does not have to have any intrinsic value; that is, it does not have to be backed by a material that has some use like gold or silver.

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Learning Objective: 2.2

17. Suppose Tom, Dick, and Harry live in a barter economy. Tom produces wine, Dick bakes bread, and Harry makes cheese. Tom wants some bread to go with his wine and is willing to trade 1 litre of wine for two loaves of bread. Dick wants some cheese to go with his bread and is willing to trade one loaf of bread for one-half kilogram of cheese. Harry doesn't want bread, but wants some wine to go with his cheese and is willing to trade cheese for one litre of wine. It is not possible for all three of them to meet together at one time.

(a) Explain how this situation illustrates the difficulty with a barter economy.

(b) Devise a money system using rubies where four rubies are equivalent in value to one litre of wine. In other words tell how much bread and cheese would be worth in terms of rubies in this economy. In this system, how much cheese must Harry sell in order to buy one litre of wine?

Ans: (a) The lack of coincidence of wants is illustrated in this situation. Tom wants the bread that Dick has, Dick wants Harry's cheese, and Harry wants Tom's wine but for any two of them there is no incentive to trade for something each does not want. In other words, there is no coincidence of wants.

(b) If rubies could be used as a medium of exchange, Tom could receive four rubies for each litre of wine. According to their initial exchange values, he should be willing to pay two rubies for each loaf of bread. Dick would then have four rubies to purchase one kilogram of cheese and Harry could buy wine with the four rubies he earned from selling this cheese. In terms of ruby prices, bread is worth two rubies per loaf and one litre of wine and one kilogram of cheese are each worth four rubies in this economy.

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Learning Objective: 2.2

18. Why does specialization require a convenient means of exchanging goods?

Ans: As consumers, individuals prefer to have a wide range of products to satisfy their desires. However, when individuals specialize in production, they focus their efforts on producing one or a few goods. This limited range of production does not match their preferences in consumption. Therefore, individuals must be able to exchange the goods that they specialize in for other goods that they desire to consume. Without a convenient means of exchanging goods, individuals could only consume what they produce. Instead, individuals would be jacks-of-all-trades producing a wide variety of products for their own consumption. There would be little incentive to specialize and to take advantage of the resulting increase in productivity.

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Learning Objective: 2.2

19. One of the characteristics of a modern market economy is an “active, but limited, government.” How can the government “help” the economy?

Ans: The market is not always perfect. In some cases it directs the economy to an undesirable outcome. We call these instances market failures. When market failures exist, the governments can direct the economy to a more efficient outcome.

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Learning Objective: 2.2, 2.4

20. What are the so-called Five Fundamental Questions that every economy must answer?

Ans: Every economy must respond to five fundamental economic questions. What goods and services will be produced? How will the goods and services be produced? Who will get the goods and services? How will the system accommodate change? How will the system promote progress?

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Learning Objective: 2.3

21. Assume that a firm can produce product A, product B, or product C with the resources it currently employs. These resources cost the firm a total of \$100 per week. Assume, for the purposes of this problem, that the firm's costs cannot be changed. The market prices and the quantities of A, B, and C these resources can produce are given as follows.

<u>Product</u>	<u>Market price</u>	<u>Output</u>	<u>Profit</u>
A	\$14.00	10	\$ _____
B	9.00	11	_____
C	.50	300	_____

- (a) Compute the firm's profit when it produces A, B, or C and enter these data in the table.
- (b) Which product will the firm produce?
- (c) If the price of A rose to \$16, which product will the firm produce?
- (d) If the firm produces A at a price of \$16, what would tend to happen to the number of firms producing product A?

Ans:

<u>Product</u>	<u>Market price</u>	<u>Output</u>	<u>Profit</u>
A	\$14.00	10	\$40
B	9.00	11	–1
C	.50	300	50

- (a) Profit for A will be \$40; for B will be –\$1 (loss); for C will be \$50.
- (b) Firm will produce product C.
- (c) If the price of A rises (assuming the firm can sell all of its output at the new price), it would make a profit of \$60 on A and so would produce product A.
- (d) If other firms face similar costs, more firms would enter industry A to take advantage of the higher economic profits.

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Learning Objective: 2.3

22. Assume that a firm can produce product A, product B, or product C with the resources it currently employs. These resources cost the firm a total of \$100 per week. Assume, for the purposes of this problem, that the firm's costs cannot be changed. The market prices and the quantities of A, B, and C these resources can produce are given below.

<u>Product</u>	<u>Market price</u>	<u>Output</u>	<u>Profit</u>
A	\$10.00	6	\$ _____
B	5.00	19	_____
C	1.50	100	_____

- (a) Compute the firm's profit when it produces A, B, or C and enter these data in the table.
- (b) Which product will the firm produce?
- (c) Suppose the quantity of product B the firm was able to produce with the same amount of inputs now rose to 25. Which product will the firm now produce?
- (d) As a result of the rise in quantity of product B to 25 that each firm can produce, what will happen to the number of firms producing product B?

Ans:

<u>Product</u>	<u>Market price</u>	<u>Output</u>	<u>Profit</u>
A	\$10.00	6	-\$40
B	5.00	19	-5
C	1.50	100	50

- (a) Profit for A will be -\$40 (loss); for B will be -\$5 (loss); for C will be \$50.
- (b) The firm will produce product C.
- (c) The firm would still choose product C.
- (d) If all firms are identical with identical costs, there will be no change in the number of firms producing product B because it is still more profitable for each firm to produce C. Thus product B is unaffected.

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Learning Objective: 2.3

23. How does consumer choice differ from consumer sovereignty in a market system?

Ans: Consumer choice by itself refers only to consumers' freedom to choose what they are willing and able to buy from what is available. Consumer sovereignty that exists in a market system goes one crucial step further. It means that producers respond to the choices that consumers make. If consumer demand declines for a particular product, that decreased demand will be reflected in prices and quantity produced. If consumer demand increases, that also will be reflected in terms of prices and quantities produced. In a centrally planned system changing consumer demand is largely ignored in favour of planners' decisions which focus on the state's goals rather than consumer wishes.

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Learning Objective: 2.3

24. Why is the consumer the king in a market system?

Ans: Consumers exert their preferences in a market system produce through their dollar votes or their purchases. When there is sufficient demand for a product by consumers, businesses that produce those products can make a normal profit. By shifting their purchases, consumers dictate to firms the types and quantities of products they desire. Businesses must respond to the wishes of consumers. When they fail to meet the desires of consumers, they make losses and eventually will cease to exist.

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Learning Objective: 2.3

25. What factors determine who will get the output?

Ans: Individuals are able to choose what they want to buy subject to their income which depends on the property and human resources they possess and the prices of those factors. In a competitive market goods will go to the persons most willing and able to pay.

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Learning Objective: 2.3

26. How is the demand for a factor of production different from the demand for a product?

Ans: Products are demanded because they satisfy the desires of consumers. Factors of production are not demanded in of their own. Instead, they are demanded because of an underlying demand for the products that they produce. The demand for factors is a derived demand. Without the underlying demand for the products that they produce, there is no demand for the factors.

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Learning Objective: 2.3

27. How does the market system accommodate change in consumer's preferences?

Ans: As consumers increase their demand for certain products, those product prices will rise and increase profitability. Producers will be induced to increase their production by hiring more workers and other factors of production.

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Learning Objective: 2.3

28. Assume that a firm finds that its profits will be maximized (or losses minimized) when it produces \$30 worth of product X. Each of these techniques shown in the following table will produce exactly \$30 worth of X.

	Unit resource Prices	Method #1	Method #2	Method #3
Land	\$1	6	3	4
Labour	2	4	3	3
Capital	3	3	4	6
Entrepreneurship	4	2	4	1

(a) Which method is most efficient? Why?

(b) Given the above prices, will the firm adopt a new method, which involves 10 units of land, 3 of labour, 2 of capital, and 2 of entrepreneurial ability?

(c) Suppose the price of capital falls to \$1 without any other prices changing. Which of the methods will the firm now choose? Why?

Ans: (a) Method #1 is most efficient because it uses relatively more of the least expensive resource, and relatively less of the more expensive resources.

(b) Yes, it is now the least-cost method.

(c) It will choose #3 because it uses relatively more of capital, which is now much less expensive, and the total cost of each method now makes #3 the least-cost combination.

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Learning Objective: 2.3

29. Assume that a firm finds that its profits will be maximized (or losses minimized) when it produces \$50 worth of product X. Each of these techniques shown in the following table will produce exactly \$50 worth of X.

	Unit resource Prices	Method #1	Method #2	Method #3
Land	\$4	4	2	1
Labour	3	4	3	6
Capital	2	3	4	3
Entrepreneurship	1	3	6	4

- (a) Which method is most efficient? Why?
- (b) Given the above prices, will the firm adopt a new method, which involves 2 units of land, 2 of labour, 4 of capital, and 8 of entrepreneurial ability?
- (c) Suppose the price of labour falls to \$1 without any other prices changing. Which of the methods will the firm now choose? Why?
- Ans: (a) Method #2 is most efficient because it uses relatively more of the least expensive resource, and relatively less of the more expensive resources.
- (b) Yes, it is now the least-cost method.
- (c) It will choose #3 because it uses relatively more of labour, which is now much less expensive, and the total cost of each method now makes #3 the least-cost combination.

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Learning Objective: 2.3

30. What is meant by the guiding function of prices?

Ans: The guiding function of prices refers to the response of producers to changes in prices. With a given supply schedule, if demand increases, the market equilibrium price will rise and producers will respond to that by producing an increased quantity of the product. Also, there may be entry of firms into the industry. Conversely, if demand decreases, the market equilibrium price will fall and producers will respond to that change by producing a decreased quantity of the product. There may also be an exodus of firms from the industry. The market system is a communications system and prices are the way information is communicated and incentives are given to take action.

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Learning Objective: 2.3

31. How can technological advance result in creative destruction?

Ans: Rival firms must follow the lead of innovative firms that are making economic profits. If the rival firms fail to do so, they can suffer economic losses and eventually fail or be bought by other firms. Sometimes technological advance actually destroys industries because an old product is no longer needed with a new innovation put on the market, a situation referred to as creative destruction. The innovation creates a new product, but in the process of doing so it effectively destroys an industry. One example would be the automobile, which eventually destroyed the market for horse-drawn carriages.

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Learning Objective: 2.3

32. Explain this quote from Adam Smith: “It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner but from their regard to their own interest.”

Ans: Adam Smith believed that sellers want to make a profit and that is the reason that they are willing to sell to consumers. They are not producing bread, beer, or meat to satisfy the hunger of their customers, but rather to earn the revenues that result from the sale of these products. If they produced due to benevolence, they would give away these products.

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Learning Objective: 2.3

33. Describe the three major virtues of a market system.

Ans: First, the market system promotes efficient use of scarce resources. Products are produced in the least costly way and the products most desired by society get produced. Second, the market system provides incentives for continual improvement and innovation. Rewards are given to entrepreneurs, workers, and consumers who attempt to make the best use of scarce resources. Third, the market system gives great support to individual freedom for producers, consumers, and workers. Each group is able to pursue their own self-interest and thus promote the social interest.

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Learning Objective: 2.3

34. “Competition is the mechanism that brings order out of potential chaos in a price-directed economy.” Explain.

Ans: This is true in the absence of government direction of production. Producers are forced to produce at lowest cost by the pressures of competition. If they don't they will not be able to sell their goods and services, because their rivals will attract the buyers at lower prices. Furthermore, producers must produce what consumers want at prices that just cover their economic costs or other producers will attract the buyers away from them. Thus, producers are driven by competition in the most efficient manner in the sense of maximizing output and the most efficient manner in terms of maximizing society's satisfaction.

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Learning Objective: 2.2, 2.3

35. “Every economy is based on 'planning' of one sort or another.” Interpret and explain.

Ans: Command economies are based on central planning by government planners. In a market system planning occurs primarily at the level of the firm, although government “planning” with regard to fiscal and monetary policy will affect economic performance. Also, government planning takes place in areas of public goods production such as highway construction and national defence. Finally, individuals plan as they make decisions about their economic futures.

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Learning Objective: 2.3-2.4

36. List two problems that have contributed to the decline of command systems on a national scale.

Ans: As a means of organizing national economies, the command system has become noticeably less popular. This is because of the coordination problem and the incentive problem. The coordination problem occurs because there are millions upon millions of individual decisions made by consumers and businesses each day. What to buy, what to sell, how to produce these things that are all questions answered by individual actions in the market system but require specific government decisions in the command system. The incentive problem occurs because without prices determined independent of planners' decisions there is no simple method to clear up cases of excess supply or excess demand. Without profits serving as a signal there is no independent method to attract resources from one productive activity to another.

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Learning Objective: 2.4

37. Explain what is meant by the free-rider problem and how a government can help solve the problem.

Ans: Private companies find it challenging to provide public goods. A road available for public use within a city is a good example. It is difficult to keep people from using the road and everyone hopes others will pay for the road so that they themselves can use it for free – this is the free-rider problem. While a private company may not build the road, a government can tax everyone to pay for it.

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Learning Objective: 2.4

38. Describe the basic features of the circular flow model.

Ans: In the simple circular flow model, there are two decision-makers: households and businesses. These two groups are related through the resource and product markets. In the upper half of the circular flow, households sell economic resources (land, labour, capital, and entrepreneurial ability) and businesses buy resources through the resource market. Businesses pay for the cost of these resources, which in turn becomes money income for households. It is the supply decisions of resources sellers (households) and the buying decisions of businesses that determine prices and employment in the resource market.

In the lower half of the circular flow, businesses sell goods and services and households buy goods and services in the product market. Households pay for these goods and services with the money income they received from providing resources. These consumption expenditures become revenue for businesses. It is the product buying decisions of households and the product selling decisions of businesses that determine prices and output in the product market.

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Learning Objective: 2.5

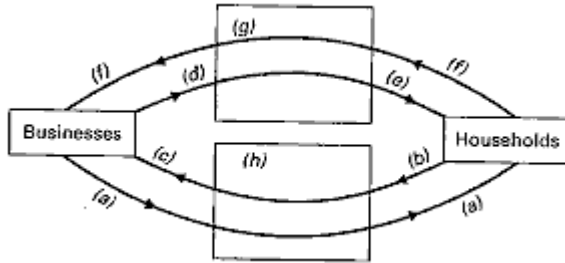
39. What is the relationship between businesses and households in the circular flow model?

Ans: Households sell their resources to firms in return for money income. Businesses combine the households' labour with other resources to create products. They offer these products for sale to households and in return receive revenue. These revenues to firms enable them to pay for the cost of resources from households as the cycle begins again.

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Learning Objective: 2.5

40. In the below circular flow diagram, the household and business sectors are labelled with arrows representing the flows of income and output labelled (a) through (f) and the two appropriate markets labelled (g) and (h). Supply the correct descriptive titles for each of these labels (a) through (h).



Ans: (a) Goods and services; (b) Consumption expenditures; (c) Revenue; (d) Costs; (e) Money income; (f) Factors land, labour, capital, entrepreneurial ability; (g) Factor markets; (h) Product markets.

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Learning Objective: 2.5

41. Explain why the market system's ability to bring organization to the economy is so very remarkable.

Ans: The number of different resources in the world is extremely large, but the number of different ways in which they could be organized is astronomically high. The fact that the market system discovers ways to organize these resources in a way that makes provides society with an ever improving quality of life is quite amazing.

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Learning Objective: Last Word