

# ECON 1000 – Contemporary Economic Issues

## “Fundamental Economic Questions and Gains from Specialization”

### Relevant Readings from the Required Textbook:

- Chapter 2, *Fundamental Economic Questions and Gains from Specialization*

### Definitions and Concepts:

- **goods and services** – outputs of the production process, such as food, clothing, shelter, healthcare, education, and entertainment
- **factors of production** – inputs in the production process, broadly categorized as land, labor, and capital
- **production** – the process by which inputs (i.e., factors of production) are transformed into an output (i.e., a good or service)
- **households** – the decision making entities whose primary objective is to obtain benefits from consuming goods and services
- **firms** – the decision making entities whose primary role is to produce goods and services for consumption by households
- **Three Fundamental Economic Questions** – when it comes to deciding how to use scarce productive resources, every society must address three fundamental economic questions: (i) What to produce? (production decision), (ii) How to produce it? (resource use decision), and (iii) For whom to produce it? (distributional decision)
- **production decision** – of all the different combinations of goods and services that we could produce, what specific combination will we produce?
- **resource use decision** – which productive resources will be used to produce which goods and services?
- **distributional decision** – who gets to consume the goods and services that we have chosen to produce?
- **production possibilities frontier** – a curve that summarizes the limits of production that a society faces by illustrating the maximum amount of one good that can be produced for every possible level of production of another good.

- **attainable output combination** – a combination of goods that can possibly be produced by a society with its available productive resources and technology (such combinations are *on or below* the PPF).
- **unattainable output combination** – a combination of goods that cannot possibly be produced by a society with its available productive resources and technology (such combinations are *beyond* the PPF).
- **productive efficiency** – a situation in which it is NOT possible to increase the amount produced of any good, without decreasing the amount produced of some other good (in such cases the society will be producing a combination of outputs *on* its PPF)
- **productive inefficiency** – a situation in which it is possible to increase the amount produced of some good, without decreasing the amount produced of any other good (in such cases the society will be producing a combination of outputs *below* its PPF).
- **absolute advantage** – a producer has an **absolute advantage** in the production of a good if she can produce more output than another producer using the same amount of inputs.
- **opportunity cost** – a general concept that refers to the cost of giving up the best alternative that must be foregone in order to do or acquire something; it measures the value of the next best use of the resources used to undertake (and provides the truest measure of the cost of engaging in) the activity being considered.
- **comparative advantage** – a producer has a **comparative advantage** in the production of a good if her opportunity cost of producing the good is lower than the opportunity cost of another worker for producing the same good.
- **Law of Comparative Advantage** – a guide for allocating scarce productive resources to various tasks, which states that when increasing the production of a good, a society should do so by using the available productive resource with the lowest opportunity cost (applying this rule allows a society to achieve productive efficiency).

### Multiple Choice Questions:

1. A.C. and Zack produce surfboards and hair gel. A.C.'s opportunity cost of producing a surfboard is lower than Zack's opportunity cost of producing a surfboard. This suggests that they can increase their total output of these two goods if A.C. focuses his production on surfboards while Zack focuses his production on hair gel.

A. Law of Absolute Advantage

- B. Law of Comparative Advantage
  - C. Cost-Benefit Principle
  - D. distributional decision
2. In regards to a Production Possibilities Frontier, which of the following statements is true?
- A. “All Attainable combinations of output are characterized by Productive Efficiency.”
  - B. “A combination of goods is characterized by Productive Inefficiency if it cannot possibly be produced with the currently available resources and technology.”
  - C. “A combination of goods is Unattainable if it cannot possibly be produced with the currently available resources and technology.”
  - D. None of the above answers are correct.
3. Which of the following is one of the “Three Basic Economic Questions” that every society must address?
- A. “Which productive resources should be used for the production of which goods?”
  - B. “How can we reduce our *carbon footprint*?”
  - C. “How can we guarantee that all people have access to health-care?”
  - D. More than one (perhaps all) of the above is one of the “Three Basic Economic Questions” that every society must address.
4. For two individuals who engage in the same two productive activities, it is generally impossible for one of the two individuals to
- A. have a Comparative Advantage in both activities.
  - B. have an Absolute Advantage in both activities.
  - C. gain from trading with the other individual.
  - D. More than one (perhaps all) of the above answers is correct.
5. Mike and Xavier spend each workday assembling bicycles and fixing computers. Mike can assemble 20 bicycles in a single day, while Xavier can assemble 15 bicycles in a single day. Based upon this information alone, we know that
- A. Mike possesses an Absolute Advantage in assembling bicycles.
  - B. Xavier possesses an Absolute Advantage in fixing computers.
  - C. Mike possesses a Comparative Advantage in assembling bicycles.

- D. More than one (perhaps all) of the above answers is correct.
6. Consider a society consisting of only three people: Andy, Bill, and Carrie. Andy and Bill spend all day producing clothing and food. At the end of each day they bring their output to Carrie, who then divides it between the three individuals. The “basic economic question” that Carrie is answering for this society is the
- A. Choice of Incentives.
  - B. Resource Use Decision.
  - C. Production Decision.
  - D. Distributional Decision.

*For Questions 7 through 9, consider a society facing the Production Possibilities Curve illustrated below:*



7. Which of the following combinations of output is “feasible but characterized by productive inefficiency”?
- A. “A” (150 Tanks and 375 bushels of Corn).
  - B. “B” (300 Tanks and 500 bushels of Corn).
  - C. “D” (210 Tanks and 1,000 bushels of Corn).
  - D. More than one (perhaps all) of the above answers is correct.
8. Starting at Point “C” (i.e., 210 Tanks and 800 bushels of Corn), if this society wanted to produce 90 more Tanks, then
- A. they could not increase their output of Corn, but they also would not have to decrease their output of Corn at all.
  - B. they could also increase their output of Corn by 90 bushels.
  - C. they would have to decrease their output of Corn by at least 300 units.

- D. they would no longer be able to produce any Corn whatsoever.
9. If this society wanted to produce 650 bushels of Corn, then their maximum output of Tanks would be
    - A. exactly 210 Tanks.
    - B. more than 210 but fewer than 300 Tanks.
    - C. exactly 300 Tanks.
    - D. more than 300 Tanks.
  10. On July 31, 2012, the Chicago Cubs traded Ryan Dempster to the Texas Rangers in exchange for Christian Villanueva and Kyle Hendricks. Since this voluntary trade took place, we can infer that
    - A. MLB Commissioner Bud Selig thought the trade was NOT in the best interest of either team, but that it would be “good for the league.”
    - B. the Chicago Cubs thought the trade was in the best interest of their own organization.
    - C. the Texas Rangers thought the trade was NOT in the best interest of their own organization.
    - D. None of the above answers are correct.
  11. is a general concept that refers to the cost of giving up the best alternative that must be foregone in order to do or acquire something.
    - A. Comparative Advantage
    - B. The Resource Use Decision
    - C. Opportunity Cost
    - D. A Property Right
  12. Ed and Fred produce Raincoats and Shirts. In a single day, Ed can produce either 60 Raincoats or 20 Shirts. Based upon this information alone, we know that
    - A. Ed’s Opportunity Cost for producing a Raincoat is “3 Shirts.”
    - B. Ed’s Opportunity Cost for producing a Shirt is “3 Raincoats.”
    - C. in order to maximize total output, Ed should focus his production on Raincoats and Fred should focus his production on Shirts.
    - D. More than one (perhaps all) of the above answers is correct.
  13. In a box of “Froot Loops” Ty received a code which could be redeemed for “one free MP3 download on Amazon.com.” Based upon a search of their website, he narrowed his choices to two songs: “Somebody that I Used to Know” by Gotye and “(Can’t Live Without) Your Love and Affection” by

Nelson. After deliberation he chose to use his code to download “Somebody that I Used to Know.” The Opportunity Cost of downloading this song is equal to

- A. zero, since he received the code for free.
  - B. the maximum amount of money he would have been willing to pay to download “Somebody that I Used to Know” if he had to instead pay “out of pocket” to download the song (i.e., if he did not have the code for “one free download”).
  - C. the amount of money which he had to pay for the box of “Froot Loops.”
  - D. the value he places on the MP3 file of “(Can’t Live Without) Your Love and Affection.”
14. “Voluntary Trade” generally
- A. makes both parties to the trade worse off.
  - B. makes both parties to the trade better off.
  - C. makes buyers better off, but sellers worse off.
  - D. makes sellers better off, but buyers worse off.
15. are the decision making entities whose primary objective is to obtain benefits from consuming goods and services.
- A. Politicians
  - B. Households
  - C. Firms
  - D. Economists
16. The Preliminary Circular Flow Diagram illustrates the
- A. movement of economic resources (i.e., factors of production and finished goods/services) between households and firms.
  - B. transfer of money between households and firms.
  - C. the limits of production that a society faces, by identifying the maximum amount of one good that can be produced for every possible level of production of another good.
  - D. gains in output that can be realized when individuals focus their efforts on producing the goods for which they possess a comparative advantage.
17. Production refers to
- A. the consumption of goods/services.
  - B. the creation of additional scarce resources/inputs.
  - C. inputs, which can be broadly categorized as land, labor, and capital.
  - D. the process by which inputs are transformed into outputs.

**Answers to Multiple Choice Questions:**

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