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*End-of-Chapter Questions and Answers*

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## Chapter 2

### Multiple Choice Questions

1. An individual's value for a good or service is the
  - a. The amount of money he or she used to pay for a good b.
  - The amount of money he or she is willing to pay for it c.
  - The amount of money he or she has to spend on goods d.
  - None of the above
  
2. The biggest advantage of capitalism is
  - a. Generates wealth with the help of government intervention
  - b. That prices assists in moving assets from high valued to low value uses c.
  - It forces involuntary exchanges
  - d. Creates wealth by letting a person follow his or her own self-interest
  
3. Wealth creating transactions are more likely to occur a.
  - With private property rights
  - b. With contract enforcement
  - c. With black markets
  - d. a and b
  
4. Government regulation
  - a. provides incentives to conduct business in an illegal black market b.
  - plays no role in generating wealth
  - c. is the best way to eliminate poverty
  - d. does not enforce property rights
  
5. An example of price floor is
  - a. Minimum wages
  - b. Rent controls in New York
  - c. Both a and b
  - d. None of the above
  
6. A price ceiling:
  - a. Is a government-set price above market equilibrium price.
  - b. Is the equivalent of an implicit tax on producers and an implicit subsidy to consumers.
  - c. Will create a surplus.
  - d. Causes an increase in consumer and producer surplus.
  
7. Taxes:
  - a. Impede the movement of assets to higher valued uses
  - b. Reduce incentives to work
  - c. Decreases the number of wealth creating transactions
  - d. All the above

8. A consumer values a car at \$30,000 and a producer values the same car at \$20,000. If the transaction is completed at \$24,000, the transaction will generate:
  - a. No surplus
  - b. \$4,000 worth of seller surplus and unknown amount of buyer surplus
  - c. \$6,000 worth of buyer surplus and \$4,000 of seller surplus
  - d. \$6,000 worth of buyer surplus and unknown amount of seller surplus
  
9. A consumer values a car at \$525,000 and a producer values the same car at \$485,000. If sales tax is 8% and is levied on the seller, then the seller's bottom line price is
  - a. \$527,000
  - b. \$523,800
  - c. \$525,000
  - d. \$500,000
  
10. Efficiency implies opportunity,
  - a. Always
  - b. Never
  - c. Only if accompanied by secure property rights
  - d. None of the above

Multiple Choice Key

1. B
2. D
3. D
4. A
5. A
6. B
7. D
8. C
9. B
10. B

Short Answer Questions

**2-1 Airline Delays**

How will commercial airlines respond to the threat of new \$27,500 fines for keeping passengers on the tarmac for more than 3 hours? What inefficiency will this create?

**2-2 Selling Used Cars**

I recently sold my used car. If no new production occurred for this transaction, how could it have created value?

**2-3 Flood Insurance**

The U.S. government subsidizes flood insurance because those who want to buy it live in the flood plain and cannot get it at reasonable rates. What inefficiency does this create?

**2-4 Goal Alignment among Physicians**

An elderly physician has built up his own practice into a quite valuable business. Now that he is

thinking of retiring, he wants to take on a partner to learn the business and eventually buy the practice in three years. Her compensation will be a salary plus 25% of the profits if they are below the historical average and 50% for any increase above the historical average. The eventual purchase price for the practice will be 5 times the average profits over the three years. Discuss the efficiency aspects of such a contract. Are the incentives of the buyer and seller aligned?

### **2-5 Kraft and Cadbury**

When Kraft recently bid \$16.7 billion for Cadbury, Cadbury's market value rose, but Kraft's market value fell by more. What does this tell you about the value-creating potential of the deal?

### **2-6 Price of Breast Reconstruction vs. Breast Augmentation**

Two similar surgeries, breast reconstruction and breast augmentation, have different prices. Breast augmentation is cosmetic surgery not covered by health insurance. Patients who want the surgery must pay for it themselves. Breast reconstruction following breast removal due to cancer is covered by insurance. The price for one of the surgeries has increased by about 10% each year since 1995 while the other has increased by only 2% per year. Which of the surgeries has the lower inflation rate? Why?

### Short Answer Key

#### **2-1 Airline Delays**

Carriers say that to avoid those fines, they will aggressively cancel flights before and during storms— even if the bad weather never materializes. The threats could foreshadow significant changes in air travel, making it even less reliable for millions of road warriors and vacationers. By canceling flights, it could take days for all travelers to get home when storms strike. [\[link\]](#).

#### **2-2 Selling Used Cars**

The value of my willingness-to-sell was less than the buyer's willingness-to-pay. Any transaction price between these allows for a voluntary exchange in which we both benefit. Since we are both better off, value was created.

#### **2-3 Flood Insurance**

Subsidies are like taxes in this case. Taxation will keep some efficient transactions from being consummated because potential transactions where the difference in buyer and seller valuation is positive will no longer cover the amount of the tax to be paid. This prevents the asset from moving to its highest valued use. With a subsidy, transactions in which the assets moves from a higher valued use to a lower valued use can be consummated so long as the difference is less than the amount of the subsidy. This moves the asset to a lower valued use. With flood insurance worth an expected \$20,000, homeowners would be willing to spend \$120,000 to build a house that they value at only \$100,000. Wealth is destroyed.

#### **2-4 Goal Alignment among Physicians**

There are a few points:

- Overlapping tenure for the retiring and new physicians tends to increase the transfer of practice specific knowledge.
- Profit sharing with the new physician increases her incentives to maximize profits.
- However, since the sale price is a multiple of the profits during this 3 year 'probation' the new physician has an incentive to shirk to keep the profits low. It might have been better to use a multiple of profits from the period before she began this probation.

#### **2-5 Kraft and Cadbury**

It means that Kraft's shareholders, and potential shareholders, think that Kraft's profits will fall. This would be the case if Kraft's \$16.7 billion bid is greater than the present value of the expected future profits from the Cadbury unit. Essentially, the combined market value of the firms separately is

greater than the market value of the firms together. The market thinks that combining these assets will destroy value.

### **2-6 Price of Breast Reconstruction vs. Breast Augmentation**

Market pressure comes from two sources: consumers who can choose not to purchase, and competitors who can offer lower prices. Breast augmentation is subject to both of these forces, and thus has a lower price, while breast reconstruction is covered by insurance where the consumer pressure is weaker.

## **Chapter 3**

### Multiple Choice Questions

1. A business owner makes 1000 items a day. Each day he or she contributes 8 hours to produce those items. If hired, elsewhere he/she could have earned \$250 an hour. The item sells for \$15 each. Production does not stop during weekends. If the explicit costs total \$150,000 for 30 days, the firm's accounting profit for the month equals:
  - a. \$300,000
  - b. \$60,000
  - c. \$450,000
  - d. \$240,000
  
2. A business owner makes 1000 items a day. Each day he/she contributes 8 hours to produce those items. If hired, elsewhere he/she could have earned \$250 an hour. The item sells for \$15 each. Production does not stop during weekends. If the explicit costs total \$150,000 for 30 days, the economic profit for the month equals:
  - a. \$300,000
  - b. \$60,000
  - c. \$450,000
  - d. \$240,000
  
3. If a firm is earning negative economic profits, it implies
  - a. That the firm's accounting profits are zero
  - b. That the firm's accounting profits are positive
  - c. That the firm's accounting profits are negative
  - d. More information is needed to conclude about accounting profits
  
4. Opportunity costs arise due to
  - a. Resource scarcity
  - b. Interest rates
  - c. Limited wants
  - d. Unlimited scarcity
  
5. After graduating from college, Jim had three choices, listed in order of preference: (1) Move to Florida from Philadelphia, (2) work in a car dealership in Philadelphia, or (3) play soccer for a minor league in Philadelphia. His opportunity cost of moving to Florida includes
  - a. The benefits he could have received from playing soccer
  - b. The income he could have earned at the car dealership
  - c. Both a and b
  - d. Cannot be determined from the given information