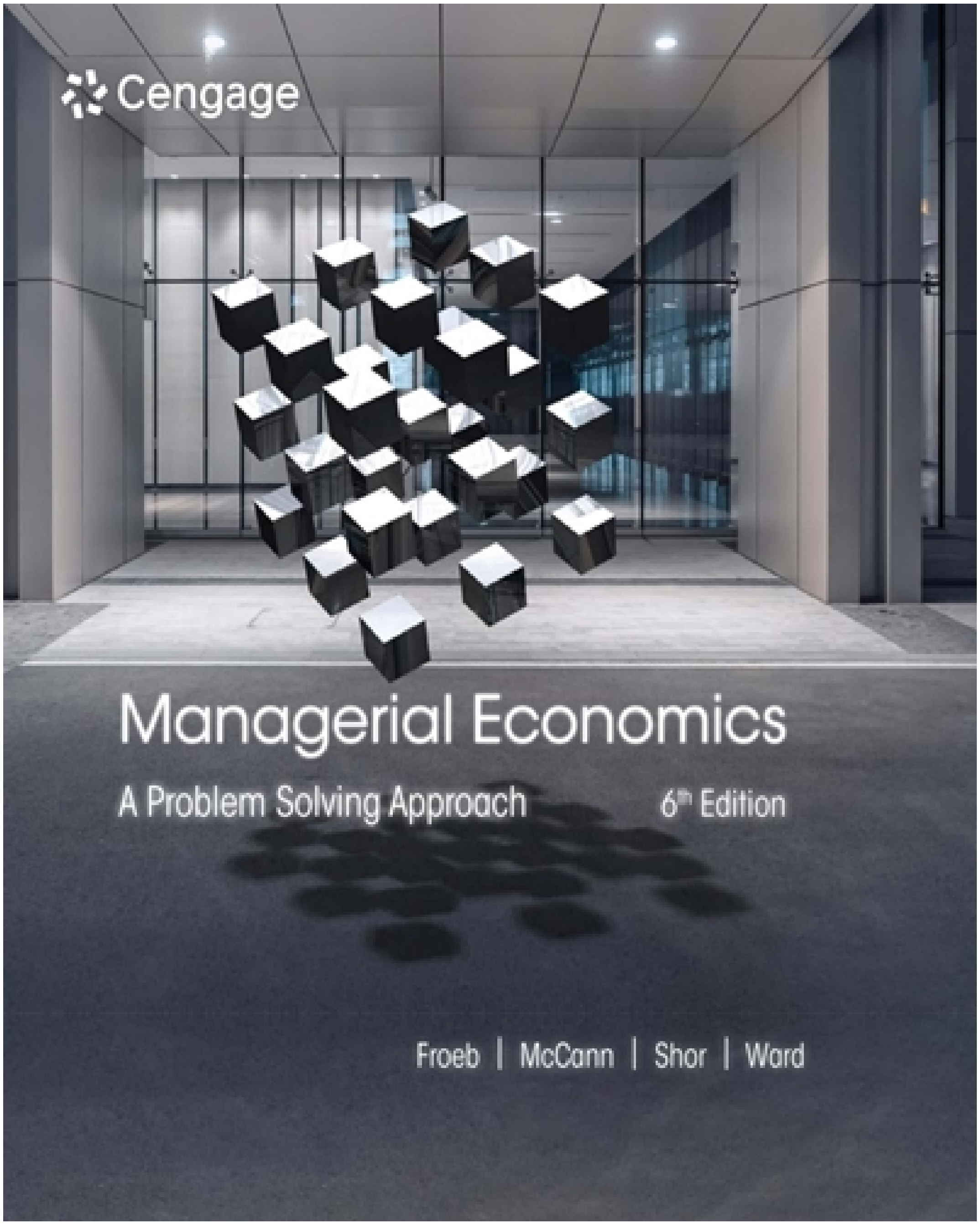
Test Bank for Managerial Economics A Problem Solving Approach 6th Edition by Froeb



Test Bank

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Chapter 02 The One Lesson of Business

1. One lesson of business:
   a. is tracing the consequences of a policy.
   b. promoting a policy change to eradicate inefficiencies.
   c. moving assets from lower to higher value uses, thereby creating wealth.
   d. is to maximize total revenue.

ANSWER: c

2. An individual's value for a good or service is
   a. the amount of money the individual used to pay for a good.
   b. the amount of money the individual is willing to pay for it.
   c. the amount of money the individual has to spend on goods.
   d. the amount of money the individual believes the supplier has spent on the goods.

ANSWER: b

3. The difference between Capitalism and Socialism is that:
   a. Capitalism is concerned more about how to slice up the economic "pie."
   b. Socialism is concerned with making the economic "pie" as large as possible.
   c. Capitalism is concerned with making the economic "pie" as large as possible.
   d. Capitalism is concerned with slicing up the economic "pie" while socialism is concerned with making the "pie" as large as possible.

ANSWER: c

4. A buyer willingly buys a good if their _______ of the good is _______ the price of the good.
   a. valuation; unrelated to
   b. valuation; only slightly less than
   c. valuation; less than
   d. valuation; greater than

ANSWER: d

5. A seller will sell a good if the price per unit of the good _______ the seller's valuation of each unit of the good.
   a. is greater than
   b. is less than
   c. is a markdown of
   d. is substantially less than

ANSWER: a

6. Transactions that are __________ create wealth by letting people follow __________.
   a. regulated; their self-interest
   b. mandated; the societal good
   c. voluntary; their self-interest
   d. socialized; the societal good

ANSWER: c

7. A consumer values a car at $30,000 and a producer values the same car at $20,000. If the transaction is completed at

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$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.

ANSWER: c

8. A consumer values a car at $30,000 and a producer values the same car at $20,000. The transaction will not take place if a tax is imposed

a. equal to the seller surplus.

b. smaller than the total surplus.

c. larger than the total surplus.

d. smaller than the buyer surplus.

ANSWER: c

9. 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, what level of sales tax will result in unconsummated transaction?

a. 0%

b. 25%

c. 20%

d. 40%

ANSWER: d

10. A consumer values a car at $30,000 and a producer values the same car at $20,000. What amount of tax will result in unconsummated transaction?

a. $4,000

b. $9,000

c. $15,000

d. $2,000

ANSWER: c

11. A consumer values a car at $30,000 and a producer values the same car at $20,000. If a tax is levied on the seller, what level of tax will result in unconsummated transaction?

a. 0%

b. 25%

c. 60%

d. 40%

ANSWER: c

12. A consumer values a house at $525,000 and a producer values the same house at $485,000. If the transaction is completed at $510,000, the transaction will generate:

a. No surplus

b. $25,000 worth of seller surplus and unknown amount of buyer surplus

c. $15,000 worth of buyer surplus and $25,000 of seller surplus

d. $25,000 worth of buyer surplus and unknown amount of seller surplus

ANSWER: c

13. A consumer values a house at $525,000 and a producer values the same house at $485,000. If the transaction is completed at $510,000, what amount of tax will result in unconsummated transaction?

a. A tax of $9,000

b. A tax of $14,000

c. A tax of $15,000

d. A tax of $18,000

ANSWER: d

14. Akio would like to sell his handcrafted bird houses at the Haggin Oaks farmers' market. After browsing the various wares at the market, a buyer finds the bird houses and is impressed with the quality of their construction. The buyer values a particularly stunning birdhouse at $412. Having spent a lot of time, effort, and money in the construction of the birdhouse, Akio has a bottom line of $223 for the birdhouse. The two haggle and eventually settle on a final sale price of $325. If the organizers of the Haggin Oaks farmers' market charged a fee of _______, then the transaction will not be consummated.

a. $35

b. $65

c. $85

d. $105

ANSWER: d

15. A consumer values a house at $525,000 and a producer values the same house at $485,000. If the transaction is completed at $510,000, what level of tax rate will result in unconsummated transaction?

a. 1%

b. 5%

c. 3%

d. 2%

ANSWER: b

16. A buyer values a house at $525,000 and a seller values the same house at $485,000. If sales tax is 8% and is levied on the seller, then what would be the lowest price that the seller would be willing to sell at?

a. $527,000

b. $523,800

c. $525,000

d. $500,000

ANSWER: b

17. Suppose that Etsy charges sellers a 6.5% fee on the sales price of all goods sold. Mariana decides to start a small business where she paints Mexican folk art on TOMS shoes and sells them on Etsy. Her cost of producing a pair of Taxco-stylized shoes is $75. A consumer values the same Taxco-stylized shoes at $175. What is the minimum price for which Mariana would be willing to sell the shoes on Etsy?

a. $163.63

b. $81.50

c. $106.50

d. $79.88

ANSWER: d

18. A buyer values a house at $525,000 and a seller values the same house at $485,000. If sales tax is 8% and is levied on the buyer, then what would be the highest price that the buyer would be willing to pay?

a. $525,000

b. $523,800

c. $485,000

d. $486,111

ANSWER: d

19. The difference between the maximum price the consumer is willing to pay and the price the consumer actually pays for a product is referred to as

a. market surplus.

b. market shortage.

c. consumer surplus.

d. producer surplus.

ANSWER: c

20. The difference between the maximum price that a buyer is willing and able to pay for each unit of a particular quantity of goods and the minimum price that a seller requires in order to recover the cost of supplying each unit of the same particular quantity of goods is known as

a. economic profit.

b. gains from trade.

c. seller surplus.

d. buyer surplus.

ANSWER: b

21. The sum of both seller and buyer surplus is known as

a. profit earned by a firm.

b. gains from trade.

c. consumer surplus.

d. producer surplus.

ANSWER: b

22. If you are willing to sell your car business for $500,000 and someone offers you $420,000 for it, this transaction will generate:

a. There is no surplus created

b. $80,000 worth of seller surplus and unknown amount of buyer surplus

c. $40,000 worth of buyer surplus and $40,000 of seller surplus

d. $80,000 worth of buyer surplus and unknown amount of seller surplus

ANSWER: a

23. If you are willing to purchase a house for $300,000 and you purchase the house for $275,000, this transaction will generate:

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a. There is no surplus created
b. $25,000 worth of seller surplus and unknown amount of buyer surplus
c. $10,000 worth of buyer surplus and $15,000 of seller surplus
d. $25,000 worth of buyer surplus and unknown amount of seller surplus

ANSWER: d

24. If you are willing to purchase a house for $500,000 and you purchase the house for $500,000, this transaction will generate:

a. There is no surplus created for either of the party.
b. $0 worth of seller surplus and unknown amount of buyer surplus.
c. $0 worth of buyer surplus and unknown amount of seller surplus.
d. Unknown amount of buyer and seller surplus.

ANSWER: c

25. Total surplus, or total gain created from trade, equals

a. seller surplus.
b. buyer surplus.
c. the sum of seller and buyer surplus.
d. profits earned by a firm.

ANSWER: c

26. An auction on eBay results in a final price of $24 for an original VHS copy of the well-received film *Predator*. The seller of the video tape of the 1987 classic values the copy at $5. Meanwhile, the buyer, an avid collector of 80's action films, has a top dollar of $33. In this case, the consumer surplus is _______, the producer surplus is _______, and the total surplus is _______. (Assume in this example that eBay does not collect a fee for providing an auction marketplace.)

a. $9; $0; $38
b. $0; $19; $38
c. $9; $19; $28
d. $19; $9; $28

ANSWER: c

27. The biggest advantage of capitalism is that

a. it generates wealth with the help of government intervention.
b. prices hinder in moving assets from high-value to low-value uses.
c. it forces involuntary exchanges.
d. it creates wealth by letting people follow their own self-interests.

ANSWER: d

28. The difference between the minimum price the producer is willing to accept and the price the producer actually receives for a product is referred to as

a. market surplus.
b. market shortage.
c. consumer surplus.
d. producer surplus.

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ANSWER: d

29. If you are willing to sell your lawn mower business for $355,000 and someone offers you $420,000 for it, this transaction will generate:
   a. There is no surplus created
   b. $65,000 worth of seller surplus and unknown amount of buyer surplus
   c. $30,000 worth of buyer surplus and $35,000 of seller surplus
   d. $65,000 worth of buyer surplus and unknown amount of seller surplus

ANSWER: b

30. Wealth is created when
   a. assets move from lower value use to higher value use.
   b. assets move from higher value use to lower value use.
   c. assets move from individuals who are willing to pay less for them to individuals who are willing to pay more for them.
   d. assets move from the rich to the people whose incomes are below the federal poverty threshold.

ANSWER: a

31. A creative entrepreneur is one who knows how to
   a. run a business.
   b. escape the burden of taxes.
   c. profitably exploit money making opportunities.
   d. extract as many favors and protections from government as possible.

ANSWER: c

32. An advantage of capitalism is that
   a. it does not allow the market to self-regulate and clear itself.
   b. it does not allow people to follow their own self interests.
   c. it does not allow voluntary transactions, which create wealth.
   d. it allows market to self-regulate and clear, allows people to follow their own self-interests, and allows for wealth-creating voluntary transactions.

ANSWER: d

33. Which of the following describes a firm?
   a. Only purchases labor hours from workers.
   b. Only borrows capital from investors.
   c. Only combines labor and capital to create production, moving them from their low value use to a high value use.
   d. Arranges labor from workers and capital from investors to produce goods such that the resources are moved from their low value uses to their high value uses.

ANSWER: d

34. If company X is successfully outsourcing its production of T-shirts to China, it:
   a. Creates wealth by moving labor in China from lower-value use to higher-value use
   b. Should be stopped on economic grounds since it is destroying wealth

c. Destroys wealth by acquiring cheaper labor from China

d. Destroys wealth by depriving labor in other countries of jobs

ANSWER: a

35. Musicians sometimes sell the right to the future proceeds of their performances to investors for lump-sums of cash (often at a discount). These are called royalties. When artists sell their royalties to investors, wealth is created by

a. shifting money from those who have a lot (investors) to those who have little (artists).

b. shifting money forward in time for musicians to satisfy their present needs and providing a steady income to investors with potential upside of securing the rights to performances of a would-be star.

c. providing untalented investors the possibility of earning a living from music.

d. providing untalented artists the possibility of earning a living from investments.

ANSWER: b

36. Suppose a retailer is operating at a loss and gets bought out by a larger chain of department stores, who then shuts down the retailer. The assets from the retailer are used by the larger chain. Which one of the following statements best captures what happens to wealth in this example?

a. Wealth is destroyed since the company shut down.

b. Wealth is created since the resources were of lesser value under the X brand and are now worth more.

c. Wealth is neither created nor destroyed since the total amount of resources stay the same.

d. Wealth is destroyed since the larger chain bought out a failing company.

ANSWER: b

37. You clean out your garage and find a copy of a computer game that you no longer wish to play. Instead of throwing the computer game CD-ROM in the trash bin, you list it on an auction website; it sells for $5. Your local government charges a $1 tax on all online sales. In this case, wealth is

a. created by enriching yourself with $4 and providing a valued good to the buyer.

b. created by providing a taxable transaction for the local government.

c. destroyed by not removing a good with zero value from the economy.

d. neither destroyed nor created because trash was simply transferred from one person to another person.

ANSWER: a

38. Government can

a. create wealth by not interfering in the markets in any way whatsoever.

b. not affect wealth in the markets.

c. create wealth by enforcing property rights and contracts.

d. create wealth by making choice decisions for the market.

ANSWER: c

39. Technological advancement creates unemployment in firms that shut down or labor that is laid off. Wealth in this case is

a. destroyed since firms are shutting down and production of certain goods and services is decreasing.

b. created since the dislocated labor and resources are absorbed by new firms created through the technological innovation, moving them to higher value use.

c. destroyed since technological progress is leading to higher unemployment.

d. created since the owners of firms save on the costs associated with compensating labor for their productive efforts.

ANSWER: b

40. You are sick and tired of your old wardrobe. You decide to donate it to a charity of your choice. Your action
 a. creates wealth by moving the clothes from lower value use to higher value use.
 b. destroys wealth since you lose your clothes.
 c. creates wealth by making you feel richer.
 d. creates wealth by making the charity richer.

ANSWER: a

41. Your cellular phone contract is due for renewal and the company offers you a new free phone. Since you want to use your new phone, you decide to recycle your old phone. Your action
 a. creates wealth by moving the phone from lower value use to higher value use.
 b. destroys wealth since you lose your phone.
 c. creates wealth by making you feel richer.
 d. destroys wealth since the company gave away the phone for free.

ANSWER: a

42. When the market is in equilibrium, with no government intervention,
 a. total surplus is minimized.
 b. total surplus is maximized.
 c. government maximizes total revenue.
 d. consumer surplus is maximized, producer surplus is minimized.

ANSWER: b

43. Price ceilings are primarily intended to help
 a. no one.
 b. consumers.
 c. producers.
 d. government.

ANSWER: b

44. Government can intervene in the market through
 a. only price floors.
 b. only price ceilings.
 c. only taxes.
 d. taxes, price floors, and price ceilings.

ANSWER: d

45. At a minimum, wealth-creating transactions require government
 a. consummating only the transactions where poor consumers have greater surplus than rich producers.
 b. establishing minimum prices that can be charged for goods and services.
 c. establishing maximum prices that can be charged for goods and services.

d. enforcing property rights and contracts.

ANSWER: d

46. Government intervention

a. can provide 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.

ANSWER: a

47. Wealth creating transactions are more likely to occur

a. without private property rights.

b. without contract enforcement.

c. with private property rights and contract enforcement.

d. with only private property rights and no contract enforcement.

ANSWER: c

48. Price floors are primarily intended to help

a. no one.

b. consumers.

c. producers.

d. government.

ANSWER: c

49. Rent controls

a. are an example of price floors.

b. are an example of price ceilings.

c. destroy wealth by preventing the movement of apartments to higher-valued uses.

d. are an example of price ceilings and destroy wealth by preventing the movement of apartments to higher-valued uses.

ANSWER: d

50. Price gouging

a. is outlawed trading at prices above a certain price level.

b. is outlawed trading at prices below a certain price level.

c. is an act of charging a high price to take advantage of shortages created by natural disasters.

d. is an act of charging a low price to undercut all competitors until they exit the industry.

ANSWER: c

51. Taxes

a. have no effect on markets.

b. cause an increase in incentives to work.

c. cause an increase in wealth creating transactions.

d. cause market distortions, reductions in incentives to work, and decreases in wealth creating transactions.

ANSWER: d

52. Economic reasoning is based on the premise that

a. all decisions or actions are costless.

b. only non-economic decisions or actions have a cost associated with them.

c. only economic decisions or actions have a cost associated with them.

d. all decisions and actions have a cost associated with them.

ANSWER: d

53. Subsidies can destroy wealth because

a. subsidies move assets from lower- to higher- valued uses.

b. subsidies move assets from higher- to lower- valued uses.

c. subsidies help producers only.

d. subsidies help consumers only.

ANSWER: b

54. A price ceiling can often be viewed as

a. the government setting price above market equilibrium price.

b. an implicit tax on producers and an implicit subsidy to consumers.

c. the government setting price below market equilibrium price.

d. the government imposing an implicit tax on producers, an implicit subsidy to consumers, and setting prices below the market equilibrium price.

ANSWER: d

55. An example of a price floor is

a. minimum wages.

b. rent controls in New York.

c. a clearance sale price.

d. an insurance maximum out-of-pocket expense.

ANSWER: a

56. Price ceilings cause:

a. Some suppliers to drop out of the market

b. A decrease in the total production in the market

c. The creation of black markets

d. At least some suppliers to drop out of the market, a decrease in total production in the market, and the creation of black markets

ANSWER: d

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Chapter 02 The One Lesson of Business

57. The illegality of organ sales from willing donors to willing recipients is ineffective because:
   a. it encourages organ sales
   b. it discourages wealth creating transactions through the threat of heavy penalty
   c. it encourages government intervention
   d. it encourages lifestyles compatible with healthy organs

ANSWER: b

58. The zero sum fallacy refers to
   a. you gaining only if someone else loses.
   b. the allocation of the pieces of the total economic "pie"—if you eat the piece, I cannot consume it.
   c. ignoring the possibility of the total "pie" growing itself.
   d. the idea that someone only gains if someone else loses, that an economic "pie" has slices that can only be consumed by one person, and does not account for the possibility of the "pie" growing itself.

ANSWER: d

59. The idea that someone must lose in order for someone else to win in a market transaction is known as
   a. the shared-cost fallacy.
   b. the zero-sum fallacy.
   c. the total-sum fallacy.
   d. the sub-zero fallacy.

ANSWER: b

60. A good policy ________ and a bad policy ________.
   a. moves an asset to higher value use; moves an asset to lower value use
   b. moves an asset to lower value use; moves an asset to higher value use
   c. refrains from any government intervention; concentrates on government intervention
   d. concentrates on government intervention; refrains from government intervention

ANSWER: a

61. When taxes are levied on transactions, irrespective of the party they are levied on,
   a. the government can absorb all the consumer surplus from the transactions as revenue.
   b. the government can absorb all the producer surplus from the transactions as revenue.
   c. the government can absorb some of the surplus, but also create a social loss since some of the wealth creating transactions are discouraged.
   d. the government can absorb all of the surplus (producer and consumer).

ANSWER: c

62. The Indian government constructs houses for the people who are homeless to move them out of the slums. Soon as these houses are constructed, the people who are homeless rent them out and move to another slum. Where could the policy have gone wrong?
   a. The policy would have been much more effective had the poor been given the cash equivalent of the house to allocate effectively by themselves.

b. The government did not allocate the funds to their highest use, as per the needs of the people who are homeless.

c. The government failed to run the policy effectively.

d. The policy would have been a better allocation of funds by giving the cash equivalent of the government-constructed house directly to the people who are homeless so they could put it to their highest-valued uses.

ANSWER: d

63. **Baseball Cards**
Your favorite uncle left you his baseball card collection in his will. Since you are not a fan, you auction them off on an Internet website. Since nothing was created, how could this decision have created wealth?

ANSWER: The transaction moved the baseball card collection from a low valued use in your possession to a higher valued use in the possession of a true fan.

64. **Moving Water Around**
The San Diablo dam has electricity generating turbines on a chute that connects lower and upper reservoirs. During the day, water is drained from the upper reservoir to the lower to produce electricity. But at night, electricity is used to pump the water back up to the upper reservoir. Since the water is just going back and forth, how can wealth be generated?

ANSWER: Peak demand for electricity is during the day when but the system has excess capacity at night. This makes electricity expensive to produce during peak times during the day but cheap to produce at night. The system uses the excess capacity to move the water uphill at night, so that it can meet peak demand during the day. In the morning, the water has a higher value at the top than at the bottom.

65. **Securities Taxes**
Congress has proposed a new tax on any transactions of securities traded on Wall Street. How would this destroy wealth?

ANSWER: In order for both the buyer and seller to benefit from a transaction the bid price the buyer is willing to pay must exceed the ask price the seller is willing to accept. With the new tax, this spread between bid and ask must be large enough to also cover the new transactions tax. This means that potential transactions in which the bid-ask spread is positive but not larger than the tax will not be consummated. Thus, the tax prevents an asset from moving to a higher valued use. [Note: Congressional spending requires the imposition of taxes. On balance, this could increase wealth if society values government services by more than the tax revenue collected plus the loss due to these unconsummated transactions.]

66. **Ethanol Mandates**
Congress has passed laws requiring that a certain percentage of retail gasoline be from ethanol produced from corn. How would this destroy wealth?

ANSWER: This regulation is mandating the movement of corn from a higher value use such as food, sugar, etc to a lower value use of gasoline (If gasoline was the highest value use you would not require a mandate!) In addition, the required use of ethanol means that petroleum from oil is not being refined. The mandate moves a high valued asset, oil, into lower, unrefined, uses. [Note: The use of oil also causes pollution, an additional cost to society. If refiners would choose to use ethanol if they bore these pollution costs, then wealth may have been created.

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Instructor Manual

Froeb/McCann/Ward/Shor, Managerial Economics: A Problem-Solving Approach, CY23, 9780357748237; Chapter 2: The One Lesson of Business

Table of Contents

Purpose and Perspective of the Chapter

Chapter 2 covers:

- Capitalism & Wealth
- Do Mergers Move Assets to Higher-Valued Uses?
- Does the Government Create Wealth?
- Economics versus Business
- Wealth Creation in Organizations

Main points in this chapter:

- Voluntary transactions create wealth by moving assets from lower- to higher-valued uses.
- Anything that impedes the movement of assets to higher-valued uses, like taxes, subsidies, or price controls, destroys wealth.
- The art of business consists of identifying assets in low-valued uses and devising ways to profitably move them to higher-valued ones.
- A company can be thought of as a series of transactions. A well-designed organization rewards employees who identify and consummate profitable transactions or who stop unprofitable ones.

Chapter Objectives

The following objectives are addressed in this chapter:

- 02.01 Understand how voluntary transactions create wealth.
- 02.02 Describe factors impeding the movement of assets to higher-valued uses.
- 02.03 Infer how efficiency helps business.
- 02.04 Identify transactions that create money-making opportunities.
- 02.05 Interpret the role of marketing in collecting and transmitting information between buyers and sellers.
- 02.06 Interpret the role of design of an organization in its wealth creation.

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Cengage Supplements

The following product-level supplements provide additional information that may help you in preparing your course. They are available in the Instructor Resource Center.

- PowerPoint Slides
- Test Bank

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What's New in This Chapter

See the Transition Guide for information on changes that have been made to this chapter.

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Chapter Outline

The following outline organizes activities and assessments by chapter (and therefore by topic), so that you can see how all the content relates to the topics covered in the text.

Chapter Introduction (PPT slide 4)

2.1 Capitalism and Wealth Creation (PPT slides 5-11)
2.2 Does the Government Create Wealth? (PPT slides 12-13)
2.3 How Economics Is Useful to Business (PPT slides 14-22)
2.4 Wealth Creation in Organizations (PPT slides 23-26)

Summary & Homework Problems

- Summary of Main points
- Multiple Choice Questions
- Individual Problems
- Group Problems

Teaching Notes

You can begin with a brief overview of “where have we been, where are we going, and how are we going to get there?” Students like this, as it puts what we are doing into perspective. In this case, remind them in the first chapter we showed students how to align the incentives of individuals with the goals of an organization (give them enough information to make good decisions and the incentive to do so); in this chapter we show them how to identify profitable decisions.

We start out talking about the wealth creating mechanism of capitalism is the movement of assets to higher valued uses, and that taxes, price controls, and subsidies slow down the movement of assets, or encourage assets to move in the wrong direction. Then remind them that decision-making in firms can either move assets to higher valued uses, or not, and that the point of this lecture is to show them how to make profitable decisions by learning how to compute the benefits and costs of a decision.

The main point of this chapter is to introduce the metaphor that ties all the business problems together: Identifying assets in lower valued uses, and then figuring out how to profitably move them to higher valued uses. Get them thinking about how to use this metaphor to help identify problems (which assets are in lower valued uses) as well as how to solve them (how do we profitably move them to a higher valued use?).

Open this class by asking students how wealth is created (by moving assets to higher valued uses). If the student answers correctly, ask the respondent what they mean by “value” (ability to pay). If you get another correct answer, confront the student by asking “do you mean that a poor student, growing up in poverty, does NOT value education?” (Yes, that is correct.). With executive MBA’s, you might want to ask students how they, or their company, create wealth. Relate it back to moving assets to higher valued uses.

The “one lesson of business” is to find assets in lower valued uses and find a way to profitably move them to a higher valued use. Alternatively, the lesson can be rephrased as seeking out unconsummated wealth creating transactions and finding ways to profitably consummate them. This theme will tie all the book chapters together.

Many students have taken a microeconomics class, and you can use a “compare and contrast” approach to explain how micro differs from managerial. Several points to reinforce:

- Economists are concerned with public policy; MBA’s with making money.
- Economics tools help you spot assets in lower valued uses and to design public policy to facilitate the movement of assets to higher valued uses. MBA’s use economics to spot assets in lower valued uses so they can buy them, and profitably move them to a higher valued use.

- Economists see inefficiency as something to be eliminated; MBA's as something to be exploited. Elimination of inefficiency is a by-product of their effort to exploit it.

Illustrate the difference between micro and managerial by looking at the effects of three policies on marginal transactions: price controls (prevent some voluntary wealth creating transactions); taxes (deter movement of some assets to higher valued uses), and subsidies (move some assets to lower valued uses). Then, after you have identified assets in lower valued uses, ask what an economist would do (change policy) and what an MBA would do (buy the asset, and sell it to someone who valued it more highly.) Focus only on the "marginal" transactions that are affected by the policies.

You may also want to talk about the role of government in facilitating wealth creating transactions. Compare and contrast countries, like Zimbabwe, with those of Hong Kong or the US (PJ O'Rourke's book, *Eat the Rich*, is great on this account). The paradox is that there is more wealth creating potential in countries like these because the government's rules have put assets in lower valued uses, but the same government rules make it difficult to move them to higher valued uses.

Close the lecture by noting that organizations have trouble creating wealth for analogous reasons: internal taxes, subsidies, or price controls that impede the movement of assets to higher valued uses within the organization. Use an example, (a favorite is Phycor, a physician management company that purchased physician practices with stock, and this reduced the incentive of physicians to work hard, essentially by turning owner/managers into stockholders of a larger entity), or refer back to the two stories in the first chapter.

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Discussion Questions

One of the best ways to engage the class is by posing in-class problem. Pose the question to the students, give them five minutes to do it; and then ask them to turn to the person sitting next to them and explain the answer. Tell them that the two best ways to learn economics are doing problems and verbally explaining the answers to someone else. When enough time has elapsed and you want to move on, tell the students to "stop learning."

In-class problem

Ask a student for an example of a price control, tax, or subsidy, and then ask them which assets end up in lower valued uses. Ask someone else if they can figure out a way to make money from the inefficiency? If you get no volunteers, ask someone to analyze the effects of the minimum wage. Do this without supply and demand; instead talk about the transactions that are deterred by the regulation (employers willing to hire at a wage below the minimum wage and those willing to work at below the minimum wage are deterred from transacting). Ask if there is a way to make money by consummating these transactions (outsourcing, start a temp agency, etc.).

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Additional Resources

Cengage MindTap Videos

- Chapter 02: Lecture Videos
- Chapter 02: Problem Walk-Through

Additional Anecdotes

In telling the anecdotes, you can give students just enough information to recognize that there is a problem. Play "20 questions" with the students where they have to ask yes-or-no questions until they figure out what the problem is, and then ask them how to fix it. Students may unconsciously begin using the rational actor paradigm. After you get the right answer, summarize the analysis for them to reinforce the benefits of using the rational actor paradigm to diagnose and solve problems: any problem can be analyzed by asking three questions:

1. Who is making the bad decision;
2. Do they have enough information to make a good decision; and
3. The incentive to do so?

Tell students that incentives have two pieces, a performance evaluation scheme and a link between compensation and performance.

Answers to the questions will suggest solutions centered on:

1. Changing decision rights (letting someone else make the decision);
2. Changing the information flow; or
3. Changing incentives (performance evaluation+compensation).

Tell them that the *art of business* is figuring out why mistakes are made and then how to fix them. Econ can teach them only to recognize the tradeoffs, but they have to figure out which solution is most profitable by balancing the costs against the benefits.

Note that this is related to Michael Jensen's famous 3-legged stool, popularized by Brickley, Smith, and Zimmerman in their textbook. You can assign a shorter version of their approach as outside reading *James Brickley, Clifford Smith, Jerold Zimmerman, "The Economics of Organizations," Journal of Financial Economics, Vol. 8:2 (Summer, 1995) pp. 19-31.* The difference is that Brickley, et al. focus on (i) Decision rights, (ii) Performance evaluation, and (iii) Compensation schemes, and just assume that if the incentives are there, individuals will find the relevant information. It may be more useful to focus on information and incentives as sometimes changing the decision rights, e.g., on pricing.

I. Zimbabwe
Discuss the following article

> "Mugabe should heed the warnings of Hayek," by Marian Tupy, *Financial Times*, Copyright 2005 The Financial Times Limited, Published: July 27 2005

The article summarizes the negative economic consequences associated with the expropriation of private property of (white) commercial farmers in Zimbabwe in 2000.

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