

Chapter 1

ECONOMIC ACTIVITY IN CONTEXT

Principles of Economics in Context (Goodwin, et al.), 2nd Edition

Chapter Overview

This chapter introduces you to the basic concepts that underlie the study of economics. We define economics as “the study of how people manage their resources to meet their needs and enhance their well-being.” This definition sets our study of economics into a broader context of concern for well-being, as opposed to the more traditional approach that focuses on markets as the sole location of economic activity. We discuss the basic questions of economics (*what, how, and for whom*), as well as the four essential economic activities (resource management, the production of goods and services, the distribution of goods and services, and the consumption of goods and services). As you work through this book, you will learn in detail about how economists analyze each of these areas of activity.

Objectives

After reading and reviewing this chapter, you should be able to:

1. Define the difference between normative and positive questions.
2. Differentiate between intermediate and final goals.
3. Discuss the relationship between economics and well being.
4. Define the four essential economic activities.
5. Illustrate tradeoffs using a production possibilities frontier.
6. Explain the concept of opportunity costs.

Key Terms

economics	capital stock
well-being	natural capital
microeconomics	manufactured capital
macroeconomics	human capital
positive questions	social capital
normative questions	financial capital
intermediate goal	stock flow
final goal	stock-flow diagram
gross domestic product (GDP)	investment
efficiency	production
economic actor (agent)	inputs
negative externalities	outputs
positive externalities	waste products
resource management	distribution

exchange
transfer
in-kind transfers
consumption
saving

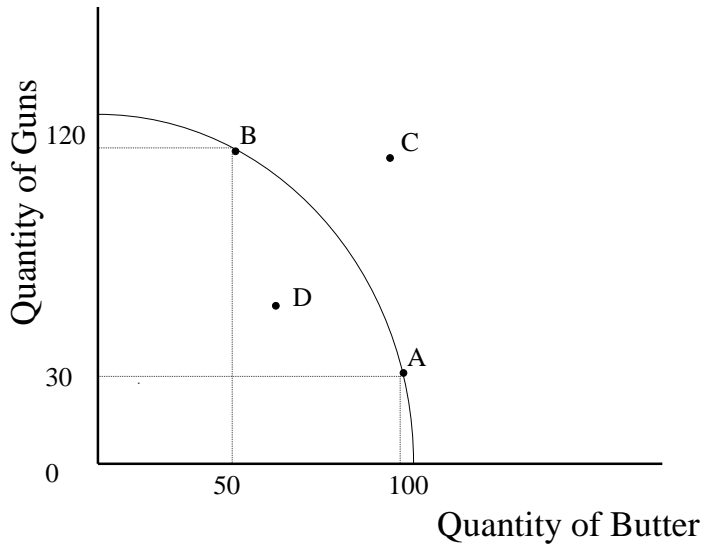
abundance
scarcity
production possibilities frontier (PPF)
opportunity cost
technological progress

Active Review Questions

Fill in the blank

1. You buy a new book. If you didn't buy the book, you would have purchased a pizza instead. Economists would call the pizza your _____ of buying the book instead.
2. A new factory begins discharging pollutants into a previously pristine river. Fish in the river begin to die, and people who make their living through fishing have trouble maintaining their catch. This factory is generating a _____.
3. Protecting wildlife in a national park is an example of the economic activity of _____.
4. Your grandmother sends you a check for \$100. This form of resource distribution is referred to as a _____.
5. A diagram that shows the tradeoffs between production of two goods is called a(n) _____.
6. A professional musician practices piano every afternoon. Her neighbor listens to the music and enjoys it. Through her activity, the musician is creating a(n) _____.
7. The activity that turns inputs into new goods and services, or outputs, is called _____.

Questions 8 to 10 refer to the production possibilities frontier shown below.



True or false

8. In the graph shown above, at point B, society is producing the maximum possible amount of butter.
9. To move from point A to point B, society would have to cut down on its gun production and increase butter production.
10. Starting from point B, society would have to invest substantial resources to increase gun production.
11. Watching a movie is an example of “consumption.”
12. The number of fish sold per day at Big City Fish Shop is an example of a stock.

Short answer

13. Name the four essential economic activities.

14. “Children should learn to clean up after themselves by the age of six.” Is this a positive or a normative statement? _____

15. “The business sphere contributed 64% of production in the US in 2016.” Is this a positive or a normative statement? _____

16. List the three basic economic questions.

17. Name the five types of capital.

18. Explain the difference between a stock and a flow.

19. What are the two main forms of economic distribution? What is the difference between them?

20. A family enjoys a three-week vacation. In order to afford this vacation, the family saved money over the course of a year. Was earning this money a final goal or an intermediate goal?

21. Technological innovations can vastly increase a society's productive capacity. How might a technological innovation affect a society's production possibilities frontier?

Self Test

1. Which of the following best exemplifies an intermediate goal?
 - a. Spending a relaxing vacation with your family.
 - b. Spending a day at the art gallery.
 - c. Going fishing for fun.
 - d. Getting a summer job so you can afford a trip abroad.
 - e. Reading a novel.

2. Which of the following statements is positive (as opposed to normative)?
 - a. One should always be polite at the dinner table.
 - b. There are ten people in this class.
 - c. A young person's top priority should be job security.
 - d. The best professor is one who meets with students individually each week.
 - e. Resources should be distributed equally across society.

3. Which of the following is an example of a positive externality?
 - a. A musician performs in a concert. People pay to listen to the concert.
 - b. An architect designs a house for herself to live in. She enjoys spending time in the house.
 - c. A student volunteers in a shelter for the homeless.
 - d. A homeowner plants a tree for shade around her house. The tree also provides shade for her next-door neighbor.
 - e. A teacher drives his car to work and gets stuck in a traffic jam.

4. Which of the following is an example of a negative externality?
 - a. A student receives a failing grade on a French exam.
 - b. Your roommate throws a loud party that keeps you awake all night.
 - c. You decide to take public transportation to work every day.
 - d. A group of farmers pool their resources to purchase seeds for next year.
 - e. You receive a letter saying your bank account is overdrawn.

5. Enjoying art at a museum is an example of ...
 - a. Production
 - b. Consumption
 - c. Exchange
 - d. Transfer
 - e. Resource management

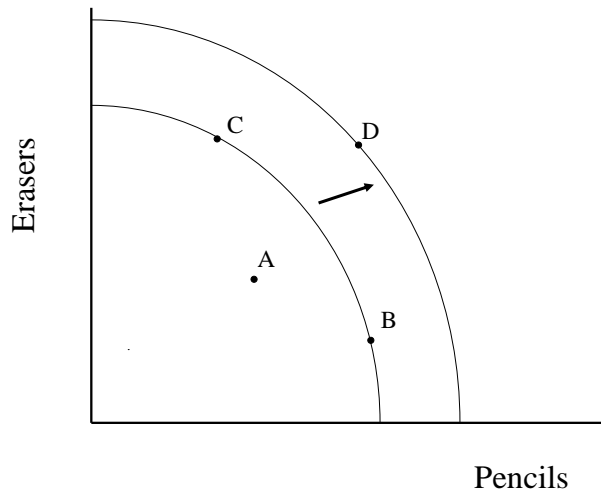
6. Which of the following statements is *false*?
 - a. Final goals could include fairness, freedom, or a sense of meaning in one's life.
 - b. You are offered a very interesting job, but you need a car to get there. Getting a car is an example of a final goal.
 - c. Resource management refers to activities associated with tending to, preserving, or improving natural, social, and other resources.
 - d. Production is the conversion of resources into goods or services.
 - e. Distribution is the sharing of products and resources among people.

7. Which of the following is an example of the economic activity of resource management?
- a. cooking dinner
 - b. operating a factory
 - c. providing worker education
 - d. drilling for oil
 - e. buying a bicycle
8. Which of the following factors could expand a society's production possibilities frontier?
- a. Increased butter production.
 - b. Shifting from one product to another.
 - c. Producing air pollution.
 - d. Depleting resources now instead of later.
 - e. Technological innovations.
9. Which of the following is an example of the economic activity of distribution?
- a. A baker makes 10 loaves of bread.
 - b. A plumber fixes a leak.
 - c. The legal speed limit is raised from 65 to 75 mph.
 - d. A couple enjoys a walk in the forest.
 - e. A retired worker receives Social Security benefits.
10. Which of the following is an example of the economic activity of consumption?
- a. A baker makes 10 loaves of bread.
 - b. A plumber fixes a leak.
 - c. The legal speed limit is raised from 65 to 75 mph.
 - d. A couple enjoys a walk in the forest.
 - e. A retired worker receives Social Security benefits.
11. Which of the following is an example of a stock?
- a. The number of haircuts you got last year
 - b. The amount of water that passes over a waterfall per second
 - c. The number of screwdrivers sold by a hardware store each week
 - d. The number of fish produced at a hatchery each day
 - e. The number of goldfish in the pet store's aquarium

12. A diagram that shows how flows change the level of a stock over time is known as a(n)
- a. flow chart
 - b. flow diagram
 - c. stock-flow diagram
 - d. input-output model
 - e. capital stock diagram
13. Which of the following is an example of a transfer?
- a. You get a new job.
 - b. You trade violin lessons for foot massages.
 - c. You buy a bag of groceries.
 - d. You make a donation to a local soccer team.
 - e. You buy stock in a start-up firm.
14. What does the Production Possibilities Frontier represent?
- a. A catalog of all possible production options, represented as percentages.
 - b. The tradeoffs between production and consumption options.
 - c. The tradeoffs between possible production levels for two goods.
 - d. The amount that a society could produce if it devoted all its resources to producing one good.
 - e. The possible gains from international trade in two or more goods.

Questions 15 and 16 refer to the following scenario.

An economy produces two goods: pencils and erasers. The graph shown below depicts two possible production possibilities frontiers (PPFs) for this economy.



15. Which of the following events could cause the economy to move from point B to point D?

- a. Workers become less productive due to poor working conditions.
- b. A hurricane destroys vital resources for pencil production.
- c. A new machine is invented that makes it easier to produce both pencils and erasers.
- d. All production costs rise proportionally.
- e. The cost of eraser inputs goes up.

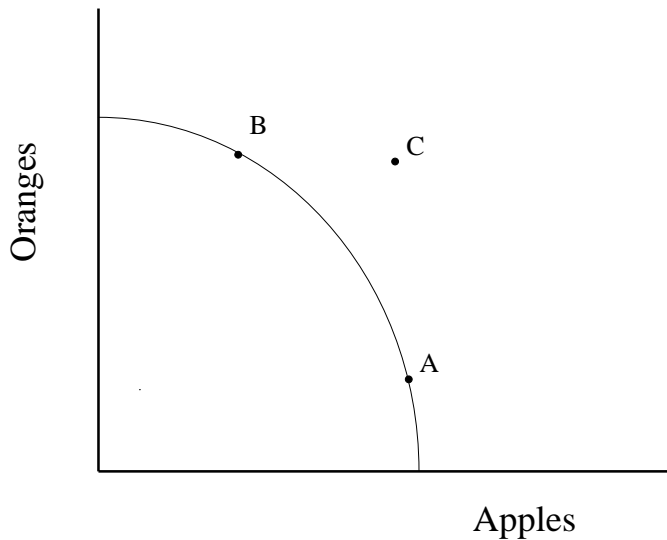
16. Which of the following statements is true?

- a. Moving from point C to point B requires shifting resources away from eraser production and into pencil production.
- b. Point B represents a less efficient resource mix than point C.
- c. Depletion of nonrenewable resources could lead the economy to shift from point C to point D.
- d. Utility is maximized at point A.
- e. At point A, society is producing all the pencils it can.

17. The nation of Anyplace produces two goods, chairs and tables. Anyplace can produce the chairs and tables using either sustainable methods or resource-depleting methods. If Anyplace chooses resource-depleting methods, which of the following statements is true?

- a. Eventually the PPF of Anyplace will shift outward (away from the origin).
- b. Eventually the PPF of Anyplace will shift inward (toward the origin).
- c. Eventually the PPF of Anyplace will pivot, causing a change in the slope of the curve.
- d. Eventually Anyplace will have to choose between producing only chairs or producing only tables.
- e. None of the above.

Question #18 refers to the graph shown below.



18. Which of the following statements is true?

- a. Point A is inefficient.
- b. Point B is inefficient.
- c. Point A is preferred to point B.
- d. Point B is preferred to point A.
- e. Point C cannot be attained with current technology.

19. Suppose there is a production possibilities frontier (PPF) for wine and cheese. Which of the following situations would shift the PPF inward (toward the origin)?

- a. A severe weather event that destroys much of the economy's productive capacity.
- b. Discovery of a new, cheaper source of milk for making cheese.
- c. Increased popularity of wine, as compared with cheese.
- d. A technological breakthrough.
- e. Improved education of the work force.

20. In general, as production of a good increases, the opportunity cost of production increases. How is this notion reflected in the graph of production possibilities frontier (PPF)?

- a. The PPF bows inwards (that is, looks like a slide or a valley)
- b. The PPF bows outwards (that is, looks like a hillside).
- c. The PPF shifts in response to technological change.
- d. The PPF shows production of one good at a time.
- e. The PPF becomes flatter as resource availability increases.

Answers to Active Review Questions

1. opportunity cost
2. negative externality
3. resource management
4. transfer
5. production possibilities frontier
6. positive externality
7. production
8. False. Society could produce more butter by producing fewer guns.
9. False. To move from A to B, society would have to decrease butter production and increase gun production.
10. True. At point B, society is already employing many of its resources to produce guns. Increasing gun production further will present high opportunity costs.
11. True. An experience can be “consumed” without using up material resources.
12. False, it’s a flow.
13. production, distribution, consumption, and resource management
14. normative
15. positive
16. What should be produced and maintained? How? For whom?
17. The five types of capital are: natural capital, manufactured capital, human capital, social capital, and financial capital.
18. A stock is something whose quantity is measured at a point in time, whereas a flow measures the quantity of something over a period of time.
19. Exchange and transfer. Exchange occurs when one actor provides a good or service, or money, in return for something else. Transfer is a one-way transaction, when one actor gives something to another.
20. intermediate
21. A technological innovation can expand the production possibilities frontier (move it “out,” away from the origin).

Answers to Self Test Questions

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|-------|-------|
| 1. d | 11. e |
| 2. b | 12. c |
| 3. d | 13. d |
| 4. b | 14. c |
| 5. b | 15. c |
| 6. b | 16. a |
| 7. c | 17. b |
| 8. e | 18. e |
| 9. e | 19. a |
| 10. d | 20. b |