**Managerial Economics:**

**A Problem-Solving Approach**

**3rdEdition**

***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
   1. The amount of money he or she used to pay for a good
   2. The amount of money he or she is willing to pay for it
   3. The amount of money he or she has to spend on goods
   4. None of the above
2. The biggest advantage of capitalism is
   1. Generates wealth with the help of government intervention
   2. That prices assists in moving assets from high valued to low value uses
   3. It forces involuntary exchanges
   4. Creates wealth by letting a person follow his or her own self-interest
3. Wealth creating transactions are more likely to occur
   1. With private property rights
   2. With contract enforcement
   3. With black markets
   4. a and b
4. Government regulation
   1. provides incentives to conduct business in an illegal black market
   2. plays no role in generating wealth
   3. is the best way to eliminate poverty
   4. does not enforce property rights
5. An example of price floor is
   1. Minimum wages
   2. Rent controls in New York
   3. Both a and b
   4. None of the above
6. A price ceiling:
   1. Is a government-set price above market equilibrium price.
   2. Is the equivalent of an implicit tax on producers and an implicit subsidy to consumers.
   3. Will create a surplus.
   4. Causes an increase in consumer and producer surplus.
7. Taxes:
   1. Impede the movement of assets to higher valued uses
   2. Reduce incentives to work
   3. Decreases the number of wealth creating transactions
   4. 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:
   1. No surplus
   2. $4,000 worth of seller surplus and unknown amount of buyer surplus
   3. $6,000 worth of buyer surplus and $4,000 of seller surplus
   4. $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 sellers bottom line price is
   1. $527,000
   2. $523,800
   3. $525,000
   4. $500,000
10. Efficiency implies opportunity,
    1. Always
    2. Never
    3. Only if accompanied by secure property rights
    4. 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](http://managerialecon.blogspot.com/2010/03/unintended-consequences.html)].

**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:
   1. $300,000
   2. $60,000
   3. $450,000
   4. $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:
   1. $300,000
   2. $60,000
   3. $450,000
   4. $240,000
3. If a firm is earning negative economic profits, it implies
   1. That the firm’s accounting profits are zero
   2. That the firm’s accounting profits are positive
   3. That the firm’s accounting profits are negative
   4. More information is needed to conclude about accounting profits
4. Opportunity costs arise due to
   1. Resource scarcity
   2. Interest rates
   3. Limited wants
   4. 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
   1. The benefits he could have received from playing soccer
   2. The income he could have earned at the car dealership
   3. Both a and b
   4. Cannot be determined from the given information
6. Economic Value Added helps firms to avoid the hidden-cost fallacy
   1. by ignoring the opportunity costs to using a capital
   2. by differentiating between sunk and fixed costs
   3. by taking all capital costs into account including the cost of equity
   4. none of the above
7. The fixed-cost fallacy occurs when
   1. A firm considers irrelevant costs
   2. A firm ignores relevant costs
   3. A firm considers overhead or depreciation costs to make short-run decisions
   4. Both a and c
8. Mr. D's Barbeque of Pickwick, TN produces 10,000 dry-rubbed rib slabs per year. Annually Mr. D's fixed costs are $50,000. The average variable cost per slab is a constant $2. The average total cost per slab then is
   1. $7.
   2. $2.
   3. $5.
   4. impossible to determine.
9. All the following are examples of variable costs, except
   1. Labor costs
   2. Cost of raw materials
   3. Accounting fees
   4. Electricity costs
10. The U.S. Government bought 112,000 acres of land in southeastern Colorado in 1968 for $17,500,000. The cost of using this land today exclusively for the reintroduction of the black-tailed prairie dog
    1. is zero, because they already own the land.
    2. is zero, because the land represents a sunk cost.
    3. is equal to the market value of the land.
    4. is equal to the total dollar value the land would yield if used for farming and ranching.
    5. depends on the value to society of black-tailed prairie dogs.

*Multiple Choice Key*

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

*Short Answer Questions*

**3-1 Concert Opportunity Cost**

You won a free ticket to see a Bruce Springsteen concert (assume the ticket has no resale value). U2 has a concert the same night, and this represents your next-best alternative activity. Tickets to the U2 concert cost $80, and on any particular day, you would be willing to pay up to $100 to see this band. Assume that there are no additional costs of seeing either show. Based on the information presented here, what is the opportunity cost of seeing Bruce Springsteen?

**3-2 Concert Opportunity Cost 2**

You were able to purchase two tickets to an upcoming concert for $100 apiece when the concert was first announced three months ago. Recently, you saw that StubHub was listing similar seats for $225 apiece. What does it cost you to attend the concert?

**3-3 Housing Bubble**

Due to the housing bubble, many houses are now selling for much less than their selling price just two to three years ago. There is evidence that homeowners with virtually identical houses tend to ask for more if they paid more for the house. What fallacy are they making?

**3-4 Opportunity Cost**

The expression “3/10, net 45” means that the customers receive a 3% discount if they pay within 10 days; otherwise, they must pay in full within 45 days. What would the seller’s cost of capital have to be in order for the discount to be cost justified? (Hint: Opportunity Cost)

**3-5 Starbucks**

Starbucks is hoping to make use of its excess restaurant capacity in the evenings by experimenting with selling beer and wine. It speculates that the only additional costs are hiring more of the same sort of workers to cover the additional hours and costs of the new line of beverages. What hidden costs might emerge?

**3-6 Dropping University Courses**

Students doing poorly in courses often consider dropping the courses. Many universities will only offer a refund up to a certain date. Should this affect their drop decisions?

*Short Answer Key*

**3-1 Concert Opportunity Cost**

$20. Opportunity cost is the value of your next best alternative. In this case, your next best alternative is attending the U2 concert. Your value for this alternative is $100 with a corresponding cost of $80 leaving a net value of $20.

Note: This question is adapted from Paul J. Ferraro and Laura O. Taylor (2005) "Do Economists Recognize an Opportunity Cost When They See One? A Dismal Performance from the Dismal Science", Contributions to Economic Analysis & Policy: Vol. 4: No. 1, Article 7.

**3-2 Concert Opportunity Cost 2**

What you paid three months ago is irrelevant to your costs now. The decision you are facing is to attend the concert or not. If you do not attend, you can sell the tickets for $225 (ignoring any brokering fees and hassle costs). Thus, you forego $450 to attend the concert.

**3-3 Housing Bubble**

These two homeowners have virtually identical houses that should sell at virtually identical prices. The purchase price from years ago is a sunk cost and therefore irrelevant to the pricing decision. They are committing the sunk cost fallacy.

**3-4 Opportunity Cost**

The "opportunity cost" of receiving a late payment is the foregone benefit of receiving the money early.  This is determined by a firm’s cost of capital.  A 3% interest rate for 35 days corresponds to an annual rate of about 3%\*(365/35)=31%.

**3-5 Starbucks**

There could be many hidden costs. Here are a few examples:

* Some of Starbucks current baristas are underage and are not permitted to serve alcohol. Hiring new bartenders may raise the labor costs.
* The storage and preparation of cold drinks, like beer and wine, differs considerably from the storage and preparation of hot drinks, like coffee. This suggests two separate “production lines” at each store.
* The Starbucks brand is known for signaling a quiet, comfy place to linger in small groups or alone. Serving alcohol may change the atmosphere enough that traditional coffee drinkers in the afternoon and early evening will be turned off.
* The Starbucks brands is also known for high quality coffees that are high quality partly because of the care in choosing beans, roasting them and brewing on the premises. It is not clear that there is much scope for care in 'preparing' beer and wine beverages to add similar value. If not, this brand extension could dilute the signal of the brand.

**3-6 Dropping University Courses**

Before this date, the tuition is avoidable. After this date, it is sunk. Before this date, students compare the expected benefits to the tuition cost. After this date, they compare the expected benefits only to avoiding the hassle costs of continuing to participate in the course.