

Chapter 2

Transactions and Institutions: The Building Blocks

TRUE/FALSE

1. In a two-person exchange, if the price offered to the seller is less than the opportunity cost of production, the exchange will not take place.
ANS: T PTS: 1 DIF: Easy NAT: Analytic
2. The closer the exchange price is to the valuation of the buyer, the greater the buyer's share of the economic value created by the exchange.
ANS: F PTS: 1 DIF: Medium NAT: Reflective Thinking
3. Price tags reduce transaction costs in countries where people's time is more valuable.
ANS: T PTS: 1 DIF: Easy NAT: Analytic
4. Transaction costs increase the economic value of an exchange.
ANS: F PTS: 1 DIF: Easy NAT: Analytic
5. The higher the transaction cost of an exchange, the lower the probability of the exchange taking place between the buyer and the seller.
ANS: T PTS: 1 DIF: Easy NAT: Analytic
6. A production point is economically efficient as long as it lies within the production possibilities set.
ANS: F PTS: 1 DIF: Easy NAT: Analytic
7. Natalie can produce 6 shirts in a day, or cook three meals. Her opportunity cost of producing a shirt is 2 meals.
ANS: F PTS: 1 DIF: Medium NAT: Reflective Thinking
8. In a two-person economy, Adam and Brandon both produce corn and cars. Adam's marginal cost of producing a car is 50 tons of corn, while Brandon's marginal cost is 70 tons of corn. In this economy, Brandon should produce cars and Adam should produce corn.
ANS: F PTS: 1 DIF: Medium NAT: Reflective Thinking
9. Specializing on the basis of marginal cost of production and trading allows both parties to consume more than their respective production sets would allow.
ANS: T PTS: 1 DIF: Medium NAT: Analytic
10. If a country has absolute advantage in the production of all goods, then it will have no incentive to trade.

ANS: F PTS: 1 DIF: Easy NAT: Reflective Thinking

11. With technological developments, more resources are discovered which change production sets for countries and make world trade more and more beneficial.

ANS: T PTS: 1 DIF: Easy NAT: Reflective Thinking

12. The laws of contracts and their enforceability in court determine the range of transactions that we will find it worthwhile to undertake.

ANS: T PTS: 1 DIF: Easy NAT: Analytic

13. Standardized goods and services sold in the market are likely to have high switch-over costs.

ANS: F PTS: 1 DIF: Easy NAT: Analytic

14. When a hierarchy is in place where one person can give orders which others must follow, the price of the specific task the subordinates are being asked to perform goes undetermined.

ANS: T PTS: 1 DIF: Easy NAT: Analytic

MULTIPLE CHOICE

1. An exchange will take place between two parties as long as:
- the seller benefits from it.
 - the buyer benefits from it.
 - any one of the parties benefit from it.
 - both the parties benefit from it.

ANS: D PTS: 1 DIF: Easy NAT: Analytic

2. Tim's opportunity cost of selling his car is \$20,000. Rebecca, who is a likely buyer, values that car at \$25,000. Calculate the economic value this transaction can create if Rebecca pays \$23,500 for Tim's car.
- \$1,500
 - \$5,000
 - \$3,500
 - \$2,000

ANS: B PTS: 1 DIF: Medium NAT: Analytic

3. The lowest price Jacob will accept from Harold for a bushel of corn produced in his farm is \$5. The transaction will go through if:
- Harold's valuation is less than Jacob's.
 - Harold's valuation is greater than \$5.
 - Jacob's opportunity cost is greater than Harold's.
 - Jacob's opportunity cost is equal to Harold's.

ANS: B PTS: 1 DIF: Medium NAT: Reflective Thinking

4. Joanne rents out her apartment in Seattle to Alice as she is moving to Dallas for the next three years. Which of the following statements must be true?
- Alice's valuation of the apartment is higher than Joanne's opportunity cost of renting it.

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- b. Joanne's valuation of the apartment is higher than Alice's.
- c. This transaction creates no economic value for Alice.
- d. Alice's valuation of the apartment is lower than Joanne's opportunity cost of renting it.

ANS: A PTS: 1 DIF: Medium NAT: Reflective Thinking

5. Suppose a seller's opportunity cost matches a buyer's valuation of the product. Assuming a two-person economy, which of the following statements will be true?
- a. The transaction will benefit the buyer, while the seller will neither gain nor lose from it.
 - b. The economic value created by this exchange will be zero.
 - c. Both parties will be worse-off after the transaction.
 - d. The seller will be worse-off than the buyer after the transaction.

ANS: B PTS: 1 DIF: Easy NAT: Analytic

6. If the transaction between you and the seller takes place at a price that equals your valuation of the product, then:
- a. you realize all the gains from this transaction.
 - b. the gains from this transaction are equally divided between the two of you.
 - c. the entire economic value created by the transaction goes to the seller.
 - d. the economic value created by this transaction is sub-optimal.

ANS: C PTS: 1 DIF: Easy NAT: Analytic

7. The shares of the economic value of a particular transaction that accrues to the seller and the buyer depend on:
- a. the buyer's opportunity cost.
 - b. the relative bargaining powers of the two parties.
 - c. the cost of production incurred by the seller while producing the good.
 - d. the lobbying techniques adopted by the two parties.

ANS: B PTS: 1 DIF: Easy NAT: Analytic

8. What matters in Economics is:
- a. how much gain a transaction yields.
 - b. how the gains from a transaction are split between the buyer and the seller.
 - c. how much gain the buyer realizes from a transaction.
 - d. that the transaction between a buyer and a seller takes place.

ANS: D PTS: 1 DIF: Easy NAT: Analytic

9. The economic value which can be created by a transaction between two people, Ed (seller) and Luis (buyer), is \$50 as Ed's opportunity cost of selling is \$135 and Luis' valuation of the good is \$185. If each gains \$25 from this transaction, which of the following conclusions can be drawn?
- a. Transaction costs are zero.
 - b. Luis has higher bargaining power than Ed.
 - c. Ed has higher bargaining power than Luis.
 - d. Transaction costs are positive.

ANS: A PTS: 1 DIF: Medium NAT: Analytic

10. The economic value which can be created by a transaction between two people, Ed (seller) and Luis (buyer), is \$50 as Ed's opportunity cost of selling is \$135 and Luis' valuation of the good is \$185. Suppose Ed and Luis do not speak the same language and Ed hires an interpreter who charges \$2 per hour. Ed and Luis finally agree to a price of \$160. This implies:

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- a. Luis' valuation of the good will increase.
- b. Ed's opportunity cost will decline.
- c. economic value from the transaction will decline.
- d. Ed will receive to a lower benefit than Luis.

ANS: D PTS: 1 DIF: Difficult NAT: Reflective Thinking

11. Suppose a buyer and a seller agree to split the cost of hiring an interpreter who charges \$4 per transaction. The seller's opportunity cost is \$35, while the buyer values the good at \$45. If the gains from this transaction are split equally between the buyer and the seller, how much will each gain from this transaction?
- a. \$10
 - b. \$4
 - c. \$3
 - d. \$5

ANS: C PTS: 1 DIF: Medium NAT: Reflective Thinking

12. Suppose a buyer hires an interpreter who charges \$5 to negotiate a deal with a seller. The buyer's valuation of the good is \$50 and the seller's opportunity cost is \$35. If the net benefit to the buyer is equal to the same received by the seller, what is the price agreed upon by the two parties?
- a. \$42
 - b. \$40
 - c. \$44
 - d. \$38

ANS: B PTS: 1 DIF: Difficult NAT: Reflective Thinking

13. Suppose the seller's opportunity cost of producing shirts is \$12 and the buyer's valuation is \$22. If the seller gains \$2 more than the buyer from this transaction, what is the price at which the good is exchanged between the two parties?
- a. \$17
 - b. \$18
 - c. \$19
 - d. \$20

ANS: B PTS: 1 DIF: Medium NAT: Reflective Thinking

14. Reducing _____ the benefits available to the buyer and seller and might also enable them to make exchanges that were previously impossible.
- a. transaction costs decreases
 - b. transaction costs increases
 - c. marginal costs decreases
 - d. marginal costs increases

ANS: B PTS: 1 DIF: Easy NAT: Analytic

15. The total cost of purchasing a car is:
- a. the dollar amount paid for it.
 - b. the dollar amount paid for it plus the seller's opportunity cost.
 - c. the dollar amount paid for it plus the buyer's opportunity cost of time spent on buying it.
 - d. the dollar amount paid for it plus the seller's opportunity cost of the time spent on looking for a buyer.

ANS: C PTS: 1 DIF: Easy NAT: Analytic

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16. Which of the following statements is true regarding the opportunity cost of time?
- Retired people are more likely to visit supermarkets than farmers' markets.
 - Students are more likely to visit farmers' markets even during exams.
 - Working professionals are more likely to frequent convenience stores.
 - The opportunity cost of time for farmers and buyers participating in the farmers' market is usually very high.

ANS: C PTS: 1 DIF: Easy NAT: Analytic

17. In the early twentieth century, general stores in the upper Midwest had more power over prices because:
- they acted as intermediaries between farmers and buyers.
 - the transportation network was bad, leaving farmers and buyers with no alternatives except the general stores in small towns.
 - inventories at the general stores were low and demand was high.
 - stockouts were a chronic problem and there was little variety.

ANS: B PTS: 1 DIF: Easy NAT: Analytic

18. The main reason Sears Roebuck became the largest retailer in the United States during the late nineteenth century was that:
- it reduced a host of transaction costs which allowed higher profits to shareholders and lower prices to customers.
 - the railroad network improved substantially and charged higher rates for transporting goods.
 - the lack of competition lowered the cost of advertising and increased profits for shareholders.
 - his organization only interacted with the best wholesalers, distributors, and shippers in the business.

ANS: A PTS: 1 DIF: Easy NAT: Analytic

19. Inefficient use of resources leads to:
- production bundles inside the production set.
 - production bundles outside the production set.
 - a reduction in the production set.
 - production of a combination on the production set.

ANS: A PTS: 1 DIF: Easy NAT: Analytic

20. Suppose Zia spends her time picking berries and apples. Her production set is described by the equation $x + 2y = 40$, where x is the number of berries and y the number of apples. Which of the following statements will be true?
- 25 apples and 10 berries is achievable but inefficient.
 - 10 berries and 2 apples is efficient but unachievable.
 - 20 apples and 5 berries is an inefficient level of production.
 - 30 berries and 5 apples is an efficient level of production.

ANS: D PTS: 1 DIF: Medium NAT: Analytic

21. Brett, who is a chef, divides his time between fishing and cooking meals. His production set is described by the equation $x + 4y = 15$, where x is the number of salmon he catches and y the number of meals he cooks. If Brett catches 5 salmon and cooks 2 meals,

- a. he is overusing his resources.
- b. the result is economically efficient.
- c. the result is economically inefficient.
- d. he is achieving the best possible outcome.

ANS: C PTS: 1 DIF: Medium NAT: Reflective Thinking

22. If the production of 2,000 cars and 500 tons of corn during a year is economically efficient for a country which produces only these two products, which of the following conclusions can be drawn?
- a. It satisfies domestic demand completely.
 - b. The production of cars can not be increased without reducing the production of corn.
 - c. The reallocation of resources to change the production level must reduce production of both goods.
 - d. It is possible to increase the production of both if resources can be reallocated.

ANS: B PTS: 1 DIF: Medium NAT: Analytic

23. The production of 1,000 shirts leaves an apparel manufacturer with a capacity to produce no more than 1,100 trousers during a month. This implies:
- a. the production level is inefficient.
 - b. that if the production of trousers is reduced, that of shirts will also decline.
 - c. that a reallocation of resources may make previously unachievable outcomes achievable.
 - d. the production level is efficient.

ANS: D PTS: 1 DIF: Medium NAT: Reflective Thinking

24. Jake can wash 6 cars or mow 3 lawns during the same time. His marginal cost of washing a car is:
- a. mowing one-third lawn.
 - b. mowing half a lawn.
 - c. mowing one lawn.
 - d. mowing 2 lawns.

ANS: B PTS: 1 DIF: Medium NAT: Analytic

25. Fiona can iron 5 shirts or cook 2 meals in an hour. Alicia can iron 6 shirts or cook 1 meal in an hour. Which of the following statements is true?
- a. Fiona's marginal cost of ironing a shirt is greater than Alicia's.
 - b. Alicia's marginal cost of ironing a shirt is greater than Fiona's.
 - c. Alicia's marginal cost of cooking a meal is twice that of Fiona's.
 - d. Fiona's marginal cost of cooking a meal is twice that of Alicia's.

ANS: A PTS: 1 DIF: Medium NAT: Analytic

26. _____ determine the efficient pattern of specialization in production.
- a. Total costs
 - b. Opportunity costs
 - c. Marginal costs
 - d. Sunk costs

ANS: C PTS: 1 DIF: Easy NAT: Analytic

27. Fiona and Alicia divide their time equally between ironing shirts and cooking meals. Fiona can iron 5 shirts and cook 2 meals in an hour. Alicia can iron 6 shirts and cook 1 meal in an hour. If they have to iron 15 shirts and cook 5 meals, who should specialize in which activity?

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- a. Fiona should do all the work.
- b. Alicia should do all the work.
- c. Fiona should specialize in cooking meals and Alicia should specialize in ironing shirts.
- d. Alicia should specialize in cooking meals and Fiona should specialize in ironing shirts.

ANS: C PTS: 1 DIF: Medium NAT: Analytic

28. Laura's team can complete 15 reports and 5 presentations in a day. Albert can motivate his team to complete 12 reports in a day with 10 presentations. Suppose the boss needs 30 reports with 20 presentations completed during a particular day. Assigning the extra presentations to Laura's team would:
- a. lead to an efficient outcome.
 - b. push the production level inside the production set.
 - c. enhance the production level along the production set.
 - d. increase the chances of achieving the target.

ANS: B PTS: 1 DIF: Medium NAT: Reflective Thinking

29. The island nation of Sonorez produces 200 tons of wheat and 500 tons of corn. Munisia, its neighboring country, produces 400 tons of wheat and corn each. Sonorez would like to consume another 80 tons of wheat and is willing to give up a 100 tons of corn for it. Munisia on the other hand would like an extra 50 tons of corn and is willing to give up 100 tons of wheat. Which of the following conclusions can be drawn from this?
- a. The 2 countries will not trade because they will not come to a common bargain.
 - b. Sonorez will trade 100 tons of wheat for extra corn.
 - c. Munisia will trade 100 tons of corn for extra wheat.
 - d. Sonorez will trade 50 - 100 tons of corn with Munisia for 80 - 100 tons of wheat.

ANS: D PTS: 1 DIF: Medium NAT: Analytic

30. Trade between two parties is beneficial because:
- a. it ensures that the standard of living in the poorer country matches its trading partner eventually.
 - b. it enables each to consume a bundle of goods that it cannot produced domestically.
 - c. it has an immediate effect on an economy by increasing its production set.
 - d. it allows the economy of both trading partners to grow equally.

ANS: B PTS: 1 DIF: Easy NAT: Analytic

31. If you have a comparative advantage in producing a good, it implies:
- a. you have a lower marginal cost of producing that good.
 - b. you have a higher marginal cost of producing that good.
 - c. you have a lower total cost of producing that good.
 - d. you have a higher total cost of producing that good.

ANS: A PTS: 1 DIF: Easy NAT: Analytic

32. Fab Tools Inc. can produce 150 widgets and 100 axes in a month. Another company AllMyTools Inc. can produce 180 widgets and 50 axes per month. Which of the following statements is true?
- a. Fab Tools has a comparative advantage in the production of widgets.
 - b. Fab Tools has an absolute advantage in the production of both goods.
 - c. AllMyTools has a comparative advantage in the production of widgets.
 - d. AllMyTools has an absolute advantage in the production of both goods.

ANS: C PTS: 1 DIF: Medium NAT: Reflective Thinking

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33. Fab Tools Inc. can produce 150 widgets and 100 axes in a month. Another company AllMyTools Inc. can produce 80 widgets and 50 axes per month. Which of the following statements is true?
- Fab Tools has an absolute advantage in production of both goods.
 - AllMyTools has an absolute advantage in production of both goods.
 - AllMyTools has a comparative advantage in production of axes.
 - Fab Tools has a comparative advantage in production of widgets only.

ANS: A PTS: 1 DIF: Easy NAT: Analytic

34. In the example of Ireland described in the text, the country's production set shifted outward over time because:
- of technological advancements which improved its potato cultivation and overall agricultural production.
 - it gained new resources over time which enabled it to specialize and gain comparative advantage in software trade with the U.S. and Europe.
 - of new resources which allowed it to gain absolute advantage over many of its trading partners.
 - of reduction in trade barriers with the European Union.

ANS: B PTS: 1 DIF: Easy NAT: Analytic

35. Which of the following is true about the U.S. trade with Ireland post-1990?
- The U.S. became a net exporter of software to Ireland.
 - Output of potato per acre doubled with the introduction of new techniques, making the U.S. a net exporter of potatoes to Ireland.
 - The U.S. production set shifted inward and Ireland gained advantage in the production of both software and potatoes.
 - Productivity growth in the U.S. software industry was higher despite the cost-shifting innovations witnessed Ireland.

ANS: B PTS: 1 DIF: Easy NAT: Analytic

36. When the slope of a country's production set declines, it implies:
- the production set has shrunk.
 - the marginal cost of producing the good measured on the Y-axis has fallen.
 - the marginal cost of producing the good measured on the Y-axis has increased.
 - the marginal cost of producing the good measured on the X-axis has fallen.

ANS: D PTS: 1 DIF: Medium NAT: Analytic

37. With cheaper communication technology and easy flow of information between countries,
- industrial production becomes more labor intensive.
 - the pattern of employment and production can change.
 - the digital divide widens.
 - transaction costs increase.

ANS: B PTS: 1 DIF: Easy NAT: Analytic

38. Which of the following statements is true about the trends in the flow of international trade witnessed in India since its independence?
- Trade liberalization was unable to boost India's economy in the first few decades of independence.
 - Indian software exports now reflect an annual growth rate of an impressive 55 percent.
 - The opening of trade and modern telecommunications allowed India's production set to

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- expand and gain comparative advantage in software.
- d. Trade has enabled Indian engineers to command higher wages than most other nations specializing in software.

ANS: C PTS: 1 DIF: Medium NAT: Analytic

39. Identify the correct statement from the following.
- Modern telecommunications turned cities like Omaha and Bangalore into new resources for the world.
 - Being only 10 hours away from most of the industrial world enabled Anchorage, Alaska to become the busiest cargo airport in the world.
 - Call centers in the U.S. set up shop in small towns to prevent large-scale migration to bigger cities.
 - Unless a city is in an advantageous location for conducting any form of business, it is difficult to boost its economy in today's world.

ANS: A PTS: 1 DIF: Easy NAT: Analytic

40. The function of economic institutions is to:
- determine the profit margin of producers.
 - determine how much an economy benefits from trade.
 - define the environment in which we can trade.
 - define the terms of trade between nations.

ANS: C PTS: 1 DIF: Easy NAT: Analytic

41. Brandon finds that Max Solutions can supply computers with the specific configuration he needs. His company enters into a contract with Max Solutions to provide 60 custom-built desktops at an agreed price. The contract between them will ensure each of the following, EXCEPT:
- that Brandon's company does not back out and make a deal with someone else for a lower price.
 - Max Solutions does not sell the computers to another company for a higher price.
 - Max Solutions supplies the computers before the scheduled date of delivery.
 - Brandon's company compensates Max Solutions in case of cancellation of order at a later date.

ANS: C PTS: 1 DIF: Easy NAT: Analytic

42. _____ are an institution where the protocols may determine a _____ and the expected revenue of the seller.
- Contracts; buyer's pricing strategy
 - Auctions; participant's best bidding strategy
 - Auctions; participant's chances of winning the bid
 - Contracts; buyer's share of gains from the transaction

ANS: B PTS: 1 DIF: Easy NAT: Analytic

43. Which of the following statements is true regarding protocols in various types of auctions?
- An English auction requires bidders to begin with the highest price.
 - A Dutch auction starts with the lowest price any bidder is willing to pay, which is displayed in a one-handed clock.
 - In a Dutch auction, the first buyer to bid gets the item at the price shown in the one-handed clock.
 - In a second-price auction, the second-highest bidder gets the item.

ANS: C PTS: 1 DIF: Easy NAT: Analytic

44. Identify the correct statement form the following.
- Governance prevents buyers in the market from switching between sellers.
 - The cost of ending a relationship with a buyer in the market is always high for sellers.
 - Goods and the parties involved in market transactions are not interchangeable.
 - At market-clearing prices participants can rest assured that shortages or surpluses will not frustrate their expectations.

ANS: D PTS: 1 DIF: Medium NAT: Analytic

45. Contracts are:
- are command-based systems in which prices usually play a relatively small role.
 - a set of promises intended to create economic value and enforceable by a court or some other agency, such as an arbitrator.
 - are a mode of governance that facilitate the purchase and sale of standardized goods or services, often in repeated transactions.
 - economic institutions that can greatly ease the process by which a transaction moves from proposal to commitment.

ANS: B PTS: 1 DIF: Easy NAT: Analytic

46. Which of the following statements is true of contracts?
- They are used only in case of standardized transactions.
 - They protect a seller's investment in the transaction.
 - They allow the concerned parties to benefit from short-term price fluctuations in the market.
 - They reduce the impact of market risk on the transaction as well as economic value in the long run.

ANS: B PTS: 1 DIF: Medium NAT: Analytic

47. Prices play a smaller role in _____, in contrast to other modes of governance like _____ and _____.
- hierarchies; markets; contracts
 - contracts; hierarchies; markets
 - markets; hierarchies; contracts
 - etiquette; markets; contracts

ANS: A PTS: 1 DIF: Easy NAT: Analytic

48. Megan, an analyst in Ronald's team called in sick on a day when 4 projects were due for completion. Ronald divided Megan's work between the remaining six team-members. Which form of governance is being used here?
- Etiquette
 - Hierarchy
 - Contract
 - Market

ANS: B PTS: 1 DIF: Medium NAT: Reflective Thinking

49. Which of the following is an example of market governance?
- A firm vertically integrating backward to own the necessary inputs
 - A firm entering into a contract with input suppliers.
 - A school recruiting a part-time teacher to cover for a permanent employee who falls very ill.

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d. A school requesting its permanent employees to cover for a teacher who suddenly falls ill.

ANS: C PTS: 1 DIF: Medium NAT: Analytic

SHORT ANSWER

1. What are the conditions that an exchange must satisfy in order to make two individuals participate in it?

ANS:

Two individuals or parties will enter into a deal to exchange economic goods only when the result makes both of them better-off. The deal must be voluntary on both sides and must benefit both parties involved.

PTS: 1 DIF: Easy NAT: Analytic

2. What is a seller's opportunity cost?

ANS:

A seller's opportunity cost is the dollar value of the best alternative he forgoes when he parts with the object. It is the lowest dollar value that the seller will accept for parting with his good.

PTS: 1 DIF: Easy NAT: Analytic

3. What is economic value of an exchange?

ANS:

Economic value of an exchange is defined as the difference between the buyer's valuation of the good and the seller's opportunity cost of parting with the good.

PTS: 1 DIF: Easy NAT: Analytic

4. Why do economists show little interest in how the benefits from an exchange are shared between the two parties?

ANS:

To economists, what matters most is that the exchange between two individuals takes place whenever an opportunity for the same arises. The fact that exchange benefits both parties is a positive statement. However, normative economics has no way to determine which of the two individuals deserves a higher share of the benefit resulting from the exchange.

PTS: 1 DIF: Easy NAT: Analytic

5. Identify some of the possible transactions costs involved in an exchange of a used car between two individuals.

ANS:

Transaction costs include the costs incurred by the seller and the buyer of the used car to locate each other. The transportation costs involved in meeting each other as well as the time involved in bargaining for a price is also a part of the transaction cost of this deal. If they do not speak the same language the services of an interpreter will add to the transaction cost.

PTS: 1 DIF: Easy NAT: Analytic

6. Transaction costs reduce the benefit accruing to the parties involved in an exchange. Explain why.

ANS:

Transaction costs reduce benefits to the two parties because a part of the economic value goes into funding the transaction cost.

PTS: 1 DIF: Easy NAT: Analytic

7. What is a production set?

ANS:

A production set is all possible combinations of goods and services that an economy can produce with its available resources.

PTS: 1 DIF: Medium NAT: Analytic

8. What causes an economy to produce a level of output which lies inside the production set?

ANS:

Inefficient use of resources causes an economy to produce an output which lies inside a production set.

PTS: 1 DIF: Easy NAT: Analytic

9. What is the marginal cost of producing one unit of A for an economy that produces only two goods, A and B.

ANS:

The amount of B that must be given up to produce an extra unit of A is the marginal cost of producing one unit of A.

PTS: 1 DIF: Easy NAT: Analytic

10. What is the marginal cost rule of specialization?

ANS:

The marginal cost rule of specialization states that an individual/economy should specialize in the production of the good in which the individual's/country's marginal cost of production is lower.

PTS: 1 DIF: Easy NAT: Analytic

11. Why should an economy specialize and trade according to its marginal cost advantage or comparative advantage?

ANS:

Individuals and nations should specialize and trade according to comparative advantage because it ensures an efficient use of resources and benefits both trading partners by allowing them to consume more than what is domestically produced.

PTS: 1 DIF: Medium NAT: Analytic

12. How does the discovery of new resources affect trade patterns around the world?

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ANS:

Discovery of new resources often change a nation's core competencies and enables it to specialize in newer areas where it was earlier at a disadvantage. This can change established trade patterns between nations.

PTS: 1 DIF: Easy NAT: Analytic

13. How does etiquette help in transaction of goods between two parties?

ANS:

Etiquette is an economic institution that can greatly ease the process by which a transaction moves from proposal to commitment. Parties from different cultures may have particular problems distinguishing behavior that is acceptable from behavior that is not. If an American and an Asian are unaware of each other's etiquette, a valuable transaction could be lost.

PTS: 1 DIF: Easy NAT: Analytic

14. What are the three major forms of governance and what are their dimensions?

ANS:

Transactions take place under governance arrangements that describe the opportunities available to the parties and the constraints under which they operate. The three major forms of governance are markets, contracts, and hierarchies. The two major dimensions of governance are trade-offs and mixed-modes of governance. Decisions taken under different forms of governance entail different trade-offs. On the other hand, transactions can also take place under a mix of governance modes.

PTS: 1 DIF: Easy NAT: Analytic

ESSAY

1. Mention the factors which have helped South Africa's electricity supplier, Eskom, to reduce transaction costs and distribute electricity cheaply?

ANS:

South Africa's electricity supplier, Eskom, uses the technologies of its day to cut transaction costs. Its power plants produce some of the world's cheapest electricity. Eskom faces high transaction costs in delivering and paying for power to low and unsteady income groups. As such Eskom has taken actions and invented ways to cut some important transaction costs:

a) Interior wiring: Poorer areas around large cities have only rudimentary housing, and the cost of installing safe wiring inside their walls is prohibitive. Eskom devised a new delivery system consisting of an insulated cable attached to a power line and dropped through the roof. At its end are several outlets.

b) Small quantities and limited ability to pay: The budgets of low-income people limit their power use. Even if consumers were always sure to pay monthly, billing and meter reading would be expensive relative to revenue per house. Eskom's prepayment system only allows power to flow if a magnetic-stripe card has been inserted into the outlets. Consumers can add desired amounts of money to their cards at convenient vending machines. A home display shows the amount remaining on the card.

c) Theft of cards: Poor areas are often high-crime areas, and stealing an unprotected power card would be almost as good as stealing money. Eskom lowers the transaction costs of avoiding theft by encoding a user's number on the card. Power will only flow if the card matches its owner's outlet code, making it almost worthless to a potential thief.

d) Theft of power: Power theft using unauthorized connections or bypassed meters is a major problem in poor countries. An unskilled worker can directly tap an ordinary line in minutes. Because either the producer or the legal users must pay for stolen power, their transaction costs are higher. To deter theft Eskom has re-engineered its wires so specialized tools and training are required to tap them.

PTS: 1 DIF: Easy NAT: Analytic

2. Explain how the development of telecommunications has made cities like Bangalore and Omaha important locations for the development of service trade?

ANS:

Telecommunications have increased the value and pay of English speakers around the world. Before the coming of toll-free telephone numbers, telemarketing and call-in services such as travel reservations (since taken over by the Internet) were minor industries. As these services grew in volume during the 1970s, Omaha, Nebraska, became home to the largest number of call centers. Its location became a resource because it was in the center of the country, which was important when rates varied more with distance than they do today. It also had the highest-capacity telecommunications network of any major city because it was adjacent to Strategic Air Command Headquarters during the Cold War. As growth drove up the wages of call-center workers in Omaha, their owners discovered another resource. They set up shop in farm towns where job opportunities were vanishing with population decline.

What happened in Omaha is now happening in India, and for the same reason—high-quality telecommunications now make English-speaking call-center workers there an economical alternative to Americans. Bangalore's location thousands of miles from the United States and Europe was once a major detriment, but telecommunications have turned it into a resource. Because Bangalore is ten and a half time zones away from the United States, Americans can work on programming and design projects during their daytime and send them to India for further work during the Indian day.

PTS: 1 DIF: Easy NAT: Analytic

3. Explain the significance of economic institutions in international trade.

ANS:

Economic institutions define the environment in which people can trade. As an example, criminal law is one of many conditions that affects trade between people. The law limits peoples' opportunities, it threatens a person with punishment that may be severe enough to deter him/her from stealing goods belonging to someone else or offering to sell something illegal. The law also expands opportunities for trade. If the law makes people less likely to steal what a person produces, he/she can be more confident of earning a return on his/her investment in a facility to produce them. Institutions like laws can change with their environment. The significance of some important forms of economic institutions are discussed below:

a) Contracting: The delivery and payment obligations present in a contract along with numerous other clauses help to increase the economic value a transaction creates for the trading parties.

b) Market Protocols: Buyers and sellers often agree to use market protocols to propose and make transactions. Auctions are an institution where the protocols may determine a participant's best bidding strategy and the expected revenue of the seller. The different protocols in various types of auctions lead rational bidders to choose different strategies.

c) Etiquette: Whether two strangers can arrange a transaction that benefits them both can depend on whether they meet each other's expectations before the transaction.

PTS: 1

DIF: Easy

NAT: Analytic