Practice Questions for Microeconomics  
Taylor, chapter 2

Answers:

Qu.1: D. Individuals do not get to make a choice between inflation and unemployment; both are aggregate macroeconomic phenomena.

Qu.2: C. Budget constraints help us think about individual consumption choices between goods or over time, and in the choice between labor and leisure. A production possibility frontier is a constraint on a country's production.

Qu.3: B. The slope of a line tells us the tradeoff between the goods on the two axes, and so is the natural representation of economic tradeoffs shown by the prices of goods.

Qu.4: A. The area defined by the budget constraint shows you the opportunities available.

Qu.5: C. Efficient points are ON the budget constraint, inefficient ones UNDER the constraint, and those ABOVE the constraint violate the constraint and are impossible to attain.

Qu.6: D. The optimal choice maximizes the consumer's utility.  
[chapter 5, in the appendix on indifference curves, provides a more detailed account]

Qu.7: B. The axes can represent present savings as well as present consumption and future consumption -- indicate current income as a point on the X-axis, at (say) $ 60,000. Then if you indicate present consumption as $ 40,000, the distance between income of $ 60,000 and consumption of $ 40,000 is the $ 20,000 in savings.

Qu.8: C. Opportunity cost is shown by the slope of the budget line. So are relative prices, which reflect opportunity costs.

Qu.9: C. A rise in the interest rate makes it possible to consume more next period, even if you save just the same amount. But it is still impossible to consume more now, so the line rotates rather than shifts.

Qu.10: B. Opportunity costs include the time spent in airport screening. The money costs of screeners might be $ 20 an hour for 6 screeners, but the process may easily take half an hour of the time of 300 people. If their opportunity costs on average reflect a wage of even $ 10 a hour foregone, this would be an opportunity cost of $ 1,500.

Qu.11: D. The opportunity cost of working is the leisure given up.

Qu.12: C. Diminishing marginal utility usually means that all-or-nothing choices deliver less total utility.

Qu. 13: The budget constraint will start at 60 hours on the X-axis, representing leisure, and wind up at $ 600 on the Y-axis, representing income.

Qu. 14. The budget constraint still starts at 60 hours on the X-axis, representing leisure, but ends at $ 720 on the Y-axis, since Brad can now make $ 720 if he works the full 60 hours each week.

Qu. 15. C. We are not sure of Brad's choice: he does have the option of working shorter hours and still earning more than he did before. If he worked 40 hours a week for $ 400 when the wage was $ 10, he can now work for 35 hours and earn 35 * $12 = $ 420.
**Qu. 16. D:** All other choices do impact the interest rate in an essential and long-term: higher rates are charged to riskier borrowers, higher rates are charged to protect lenders against inflation, and lenders and borrower both consider the time value of money.

The Federal Reserve Board, although it can influence interest rates for a while, does not determine the rate of interest.

**Qu. 17: D.** Consider the sum you would have at the end of each year:

- Year 1. $5000 + .06 ($5000) = $5000 + $300 = $5300
- Year 2. $5300 + .06 ($5300) = $5300 + $318 = $5618

Note that a short cut calculation would have been $5000 (1.06) (1.06) = $5618.

**Qu.18. B.** More capital goods will make it possible to produce more in the future – the increase in capital is an increase in the resources available to the society and will shift the PPF outwards.

Both countries have attained productive efficiency if they are producing on the PPF; it is impossible to decide from the question whether either has attained allocative efficiency, since we don't know whether the high rate of investment is too high from the point of view of society's desires (the old USSR had a very high investment rate, and very few consumer goods available to the general public).

A high investment rate will normally mean that a lot of firms want to borrow money to buy capital goods and build factories, and this will drive up the interest rate.

**Qu.19. C.** Productive efficiency is necessary but not sufficient for allocative efficiency.

**Qu.20. B.** Diminishing marginal returns means that as we get closer to specialization in one good, we are using resources not as well suited to the job – and this means the PPF will fall short of a straight line at both ends.