

Common Sense Economics
Part II: Seven Major Sources of Economic Progress
Practice Test

1. Why is private ownership an important source of economic prosperity?
 - a. It eliminates the opportunity cost of using a resource.
 - b. It provides owners with a strong incentive to develop and use assets in ways that others value highly.
 - c. It allows owners to do anything they want with their property.
 - d. It makes it possible for owners to ignore the desires of others without having to bear the cost.

2. Under a system of private property, could a 60-year-old owner of a tree farm benefit by planting and caring for a crop of Douglas firs, most of which will not be ready to harvest for 50 years?
 - a. No, the farmer will be dead before the crop will be ready for harvest.
 - b. Yes, the farmer will benefit from increased valuation of the land as the trees grow and the harvest moves closer.
 - c. No, the value of the land will decline since the farmer is taking it out of production for the next 50 years.
 - d. Yes, but only if the project is subsidized by the government or private conservation groups.

3. Which of the following is most important if a country is going to achieve and sustain rapid economic growth?
 - a. high tariffs and imposition of other trade restrictions
 - b. high marginal tax rates
 - c. an open and competitive capital market
 - d. high rates of inflation

4. Even-handed enforcement of contracts fuels economic prosperity because it
 - a. permits individuals to invade or infringe on the property rights of others.
 - b. increases transaction costs.
 - c. increases market uncertainty and the probability of contract violations.
 - d. promotes gains from trade by minimizing the costs of entry and enforcement of contracts.

5. Competition is present when
 - a. subsidies assure that inefficient firms remain active in the market.
 - b. freedom of entry and rival firms are present in a market.
 - c. the market is characterized by rising prices and declining product quality.
 - d. there is little incentive to introduce new products and discover better ways of doing things.

6. What role do losses play in a competitive market?
 - a. They penalize a firm for producing a good that consumers value highly relative to its cost.
 - b. They signal that more resources are needed in this market.
 - c. They show firms that barriers to entry are high.
 - d. They send a message that more value would be created if the resources were used to produce other goods.

7. Which of the following best summarizes the importance of business failure and the central idea of “creative destruction in a market economy”?
 - a. When a business fails, the assets and resources from that business become unemployed, resulting in higher government subsidies.
 - b. Business failure allows the assets and resources from that business to move into other areas where they will be more productive.
 - c. Only through frequent business failure will it be possible to avoid income being concentrated into the hands of a few rich entrepreneurs.
 - d. The new, rival businesses that drive out old competitors tend to be less efficient and less creative than the older established businesses.

8. If a nation is going to achieve and sustain a high rate of economic growth, it must
 - a. prohibit low-wage foreign producers from supplying goods to the domestic market.
 - b. have an abundant domestic supply of low cost energy resources.
 - c. have a mechanism capable of attracting savings and channeling them into wealth-creating projects.
 - d. impose regulations that will limit the intensity of competition among domestic firms.

9. “Wal-Mart is a low-wage firm and this indicates that it exploits its workers.” Which of the following should cause one to question the validity of this statement?
 - a. the high profits of Wal-Mart
 - b. the large sales revenue of Wal-Mart
 - c. No one is required to work for Wal-Mart and, therefore, it must attract workers by paying them more attractive wages than they could earn elsewhere.
 - d. This is a trick question. Wal-Mart does exploit its workers and the below average wage of Wal-Mart employees illustrates this point.

10. In recent decades labor markets in European countries like Italy and Spain have been
 - a. less regulated and the unemployment rates of the European countries have been lower than the United States.
 - b. more highly regulated and the unemployment rates of the European countries have been higher than the United States.
 - c. less regulated and the unemployment rates of the European countries have been higher than the United States.
 - d. more highly regulated and the unemployment rates of the European countries have been lower than the United States.

11. If the government levies \$20 billion in taxes to finance additional spending on military weapons, the net impact on total employment will be
 - a. a substantial increase in employment because the additional spending will create lots of jobs.
 - b. a substantial decrease in employment because the higher taxes will destroy lots of jobs.
 - c. small because the higher taxes will reduce spending in the private sector, which will tend to offset any jobs created by the government spending.
 - d. a substantial expansion in employment, but only if the additional spending leads to an increase in the general level of prices.

12. Private entrepreneurs are likely to make better investment decisions than central planners because
 - a. the failure of a government project reduces the personal wealth of the planners involved in the decision.
 - b. entrepreneurs can often turn a project's failure into a request for additional funding to rectify the "problem".
 - c. entrepreneurs seek ever larger budgets, while planners are more focused on cost reductions and efficiency.
 - d. investors who make mistakes must bear the costs of these mistakes personally.

13. Which of the following contributed to the soaring housing prices of 2002-2005?
 - a. Regulations designed to make housing more affordable increased the demand for housing and drove housing prices upward.
 - b. Regulations designed to make housing more affordable decreased the number of sub-prime loans and made home buying a safer investment.
 - c. Mortgage lending standards tightened, and therefore mortgage loans for housing were only available to buyers purchasing highly expensive homes.
 - d. Home buyers were required to make larger down payments and this increased the demand for housing, driving housing prices up.

14. Which of the following is true of regulation?
- Regulatory agencies often ignore the secondary effects of their actions and fail to foresee future problems.
 - Policy-makers are hesitant to call for new regulations even when it is clear they would help avert future crises.
 - Mortgage lending and banking have historically been unregulated and therefore regulation in these sectors is unpopular.
 - Past regulations have been effective at averting crises, but they are unpopular because they reduce the profitability of the regulated industry.
15. Inflation is
- a persistent increase in the general level of prices.
 - a persistent increase in the price of an individual good, service or resource.
 - a one time increase in the general level of prices.
 - a one time increase in the price of an individual good or service.
16. Money is
- whatever is generally used to pay for goods, services and resources.
 - an object that is directly consumed.
 - widely used in a barter economy.
 - something that can be used to buy things but cannot be saved.
17. Monetary and price instability will
- make it easier for both individuals and businesses to plan wisely for the future.
 - generate uncertainty, and encourage investors and businesses to move their activities to countries with a more stable monetary environment.
 - encourage businesses to invest and expand their future output.
 - encourage domestic citizens to increase their rate of saving.
18. Which of the following will discourage investment?
- well-defined property rights
 - high and variable rates of inflation
 - a low and steady rate of inflation
 - low tax rates
19. The Fed's low short-term interest rate policy of 2002 to 2004 encouraged decision makers to
- make large down payments when purchasing housing.
 - purchase housing only if it could be financed with a 30-year, fixed interest-rate mortgage.
 - borrow more and increase their purchases of housing.
 - borrow less and reduce their purchases of housing.

20. Which of the following is true of taxes?
- Taxes drive a wedge between what buyers pay and what sellers receive.
 - Taxes increase the volume of mutually advantageous exchanges.
 - Increases in taxes are the primary cause of inflation.
 - Business taxes generate government revenue without imposing a burden on consumers and households.
21. Why do foreigners export goods and services to buyers in the United States?
- They want to acquire dollars so they can purchase things from Americans.
 - They like helping Americans.
 - They are forced to sell to Americans.
 - They want to harm Americans and one way of doing so is to sell goods at low prices in the U.S. market.
22. Trade restrictions like tariffs and quotas will
- protect American jobs and increase employment.
 - ensure that more dollars stay in the United States.
 - reduce the value of goods and services that we will be able to produce and consume.
 - make all Americans better off.
23. Which of the following resulted from the Smoot-Hawley trade bill of 1930?
- The stock market began a steady recovery from the crash of October 1929.
 - Many countries responded by imposing higher tariffs on American products, and the volume of international trade fell sharply.
 - Imports decreased, while exports increased, resulting in an overall increase in GDP and tariff revenues.
 - The unemployment rate, which had been rising, began to steadily decline as jobs were protected by the trade restrictions.
24. In order to achieve a high economic freedom rating, a country must
- elect political officials democratically.
 - protect property rights, enforce contracts even-handedly, and rely extensively on markets to allocate goods and services.
 - provide citizens with housing, health care, and other basic goods free of charge.
 - use the taxing power of the state to redistribute income from the rich to the poor and thereby promote income equality.

ANSWER KEY 1 THROUGH 24

1. (b), 2. (b), 3. (c), 4. (d), 5. (b), 6. (d), 7. (b), 8. (c), 9. (c), 10. (b), 11. (c), 12. (d)
13. (a), 14. (a), 15. (a), 16. (a), 17. (b), 18. (b), 19. (c), 20. (a), 21. (a), 22. (c)
23. (b), 24. (b)