Homework III

due Wednesday, February 7th in class

1. Short Descriptions (3 points) In two to three coherent sentences, explain and/or define each of the following concepts.
   (a) Rule of law
   (b) Natural monopoly
   (c) Arbitrageurs

2. Capital Markets (3 points) One of the most fundamental differences between a market economy and a centrally planned economy is the absence of capital markets in the latter. Discuss the problems of a system without the capital markets. Focus on the role of the capital markets in the “life of a firm.”

3. The Use of Knowledge (5 points) What is the main point of Hayek’s article “The Use of Knowledge in a Society?” According to the article, what is the function of prices in a market economy? How does Hayek’s article relate to one of the strengths of the market system which says that the need for information is minimized in the market system. Also, relate the time period when the article was published to the economic debates at that time.

4. Externalities (3 points) What are the four possible solutions, which we discussed in class, to economic externalities? Explain each briefly.

5. Strengths of a Market System (3 points) One of the strengths of a market system is that relative prices reflect relative costs. Explain this concept in the context of efficient allocation of scarce resources.

6. Capitalist Economic System (9 points) A Marxist makes the following points about capitalism:
   1. In capitalism, goods that are truly needed, like health care, are under-provided. Production is wasted on unnecessary goods like yachts for the rich.
   2. In capitalism, innovation leads to ways to reduce wages and to ”deskill” workers. As a result, wages are low and many alienating jobs are created.
   3. In capitalism, the rich continually get richer and the poor get poorer.
   4. In capitalism, there is a reserve army of workers. These workers escape their miserable condition by abusing drugs and alcohol.
   5. Capitalism is subject to recurring periods of recession or depression, during which unemployment is high.
   6. Freedom in capitalism is not real freedom since all but the rich are powerless.
   7. In capitalism, the government is run by the rich capitalists, not the people.
   8. Capitalism leads to monopoly control over industries.
   9. Capitalism leads to imperialism and domination over poorer countries.

Assume you are a supporter of market capitalism as it was explained in this chapter. Draft a reply to the points raised by the Marxist above. Your reply should both refute the points made by the Marxist and should make the case for market capitalism.