

Answer to Question _____1_____ (see pages 17-18 of the handout)

If markets are to produce optimal results, exchange must be voluntary and involve goods (and/or services) that have nonattenuated (not weakened or “strong”) property rights. Nonattenuated property rights have three characteristics; exclusive, transferable and enforceable. Generally, a failure of property rights is a failure of “exclusivity.” It may be noted that problems of enforcement are becoming increasingly important because of intellectual property rights.

The major failures of exclusivity include externalities (both positive and negative), public or collective goods and common property resources.

Externalities result in costs and/or benefits being imposed on others who are not involved in the market transaction. Negative externalities result in “too much” production and consumption of a good while positive externalities result in “too little” production.

Public goods (or collective goods) occur when users cannot be excluded from the use of the good and the marginal cost of an additional user is zero. The problem is that since individuals cannot be excluded (and $MC=0$) there isn't a market mechanism to provide the incentives to pay for public goods; people want to be “free riders.”

Common property resources are fugitive resources that belong to whoever captures the resource. Unlike public goods, the use of a common property resource imposes costs on others and the environment. As a result, common property resources tend to be “over used” and may be driven to extinction.

Answer to Question _____2_____ (see handout pages 3-5)

“Specialization” refers to the process by which a person, organization or country focuses on the production of a single product (or even class of products). Division of labour is the process by which the production of a single good is broken down into individual steps that can be performed by different individuals.

Plato saw specialization as being grounded in justice. Aristotle might have accepted specialization as the fulfillment of human potential that was necessary for the good life. Plato argued that if specialization occurred, it would necessitate the development of the city-state and community to facilitate exchange or distribution of the goods. David Ricardo saw that specialization contributed the increased production and welfare through comparative advantage.

Adam Smith argued that the division of labour was the primary engine that drove economic growth. However, he argued that its over use would make individuals “as dumb and stupid as possible for the human creature to become.”

Answer to Question _____3_____ (see handout pages 12-13)

Rational behavior is one way in which individuals make choices. Rational behavior is dependent upon information. Objectives must be known to the individual and feasible alternatives must be known. If both the objective and alternatives are known, then there must be criteria to evaluate each alternative with respect to the objective. Individuals' choices can only be judged as rational if the objective, alternative and criteria are known. Rationality as a basis for decision-making requires an understanding of the cost and nature of how information (or knowledge) is acquired.

Answer to Question _____4_____ (see handout pages 16-19)

Reciprocity is an allocative mechanism that relies on creating obligations of gift giving while market exchange relies on voluntary *quid pro quo* contracts. In market exchange, the terms of the exchange must be known and agreed to (voluntarily) by all affected parties. In reciprocity, the obligations established by the gift process are not specific and may be based on kinship or other social relationships. The crucial difference is that reciprocity is based on social relationships while exchange is based on contract. Elements of trust are needed for both exchange and reciprocity but reciprocity requires a sense of community to enforce the obligation.

Answer to Long Answer - Question _____1_____ (see Kelo v. New London and class discussion)

The case of Kelo v. New London deals with the issue of eminent domain. It is concerned with the ability of an authority to take a person's private property for “public use” or “public purpose.” Historically eminent domain has been used to take private property for public use. There have been a few cases where it was take for public purpose. Public use implies that the property is used for some public project (a road, dam, canal, military base, etc). Kelo v. New London is about a case where the property rights were transferred to one private party (actually nine people with 15 units of property) to another private company (a private development corporation created for New London, Connecticut). This has been done in the past where the private company that received the property rights used it for a Railroad or a athletic stadium but never where it was for private development.

The decision in the case was upheld (5 to 4) to allow property to be taken if the property would be used for a more profitable purpose. The dissenting opinion (Justice O’Conner) argues that the ruling blurs the distinction between public use and private use of property. As a consequence this means that if a private party is not using their property in its “highest valued” use, the public authority can transfer the property rights to another private party who will use the property more effectively. O’Conner argues that this means that any Motel Six could be replaced by an upscale hotel, anyone’s home could be replaced by a shopping mall or any farm by a factory.

Further, O’Conner argues that the effects of this decision are not random. Nor, in the terminology of the class, the results are not Pareto Optimal. The beneficiaries will be those with power in the political process. She specifically mentions large corporations and development firms. The losers are those with less political power.

Answer to Long Answer - Question ____2____ (Class discussion and handout)

The economic problem is based on the problem of scarcity. The means of production are finite and wants are unlimited (or at least exceed the ability to produce). Every society must devise a system to resolve the problem of scarcity. Since every individual may have objectives and preferences that are in conflict with others and society, the primary task is to coordinate human activity to allocate, produce and distribute the material and intangible means of life.

Humans deal with the problem of scarcity through the use of social interaction and technology. Individuals acting together can often accomplish goals or objectives they cannot achieve acting alone. The question is how the behavior of individuals can be coordinated to achieve objectives.

This problem must be dealt with at two levels. First, it is necessary for groups (societies or groups) to devise the rules of the game that determine which of the various mechanisms to be used. The rules of the game or the structure of the economic system is determined by both implicit and explicit institutions and organizations. The mores, custom, traditions and social institutions influence the behavioral patterns of individuals in society.

At the second level, it is necessary to answer the 5 basic economic questions:

- What to produce?
- How much to produce?
- How to produce?
- When to produce?
- Who gets it?

The answers to these questions require information about objectives, alternatives and probabilities of achieving goals. It is also necessary that there be a system of incentives to encourage or enforce behavioral patterns that result in a cohesive and stable society that achieves the common objectives to a reasonable degree.

In the evolution of the institutional structure within which the economic system functions, there are several allocative mechanisms that are possible. These include:

- Market exchange
- Reciprocity
- Eminent domain
- Philanthropy
- Theft
- Inheritance

The emphasis that an economic system places on these allocative mechanisms and the combinations of mechanisms that are used is fundamental to the nature of an economic system.